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Chart attack

"In the United States neither paper currency nor deposits have value as commodities. Intrinsically, a dollar bill is just a piece of paper, deposits merely book entries. Coins do have some intrinsic value as metal, but generally far less than their face value. What, then, makes these instruments – cheques, paper money, and coins – acceptable at face value in payment of all debts and for other monetary uses ? ***Mainly, it is the confidence people have that they will be able to exchange such money for other financial assets and for real goods and services whenever they choose to do so***."

- 1961 Federal Reserve Bank of Chicago paper, via Zero Hedge.

"US Economy Grinds To Halt As Nation Realizes Money Just A Symbolic, Mutually Shared Illusion"

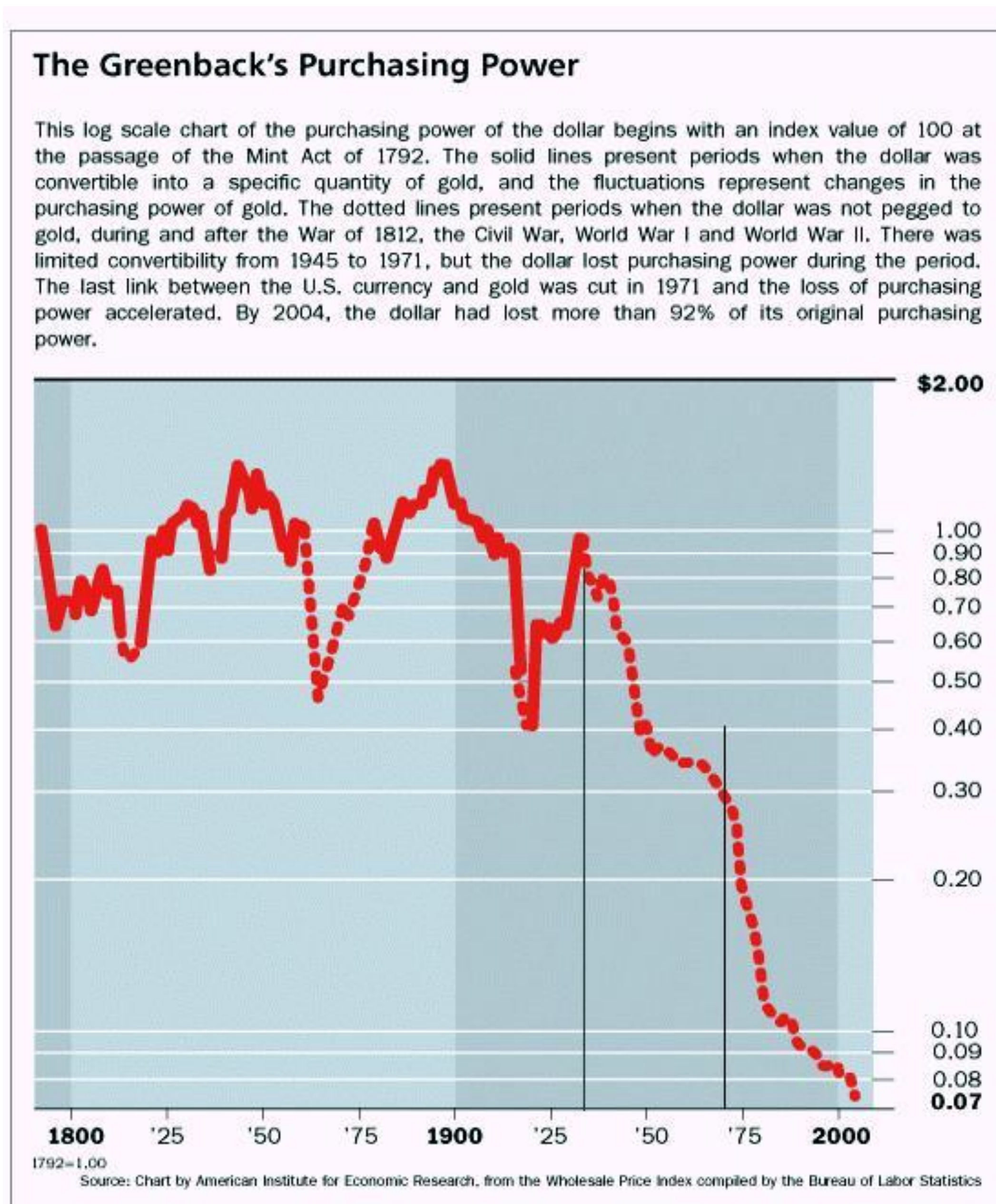
- Headline from The Onion.

Historians are taught to discriminate between primary and secondary sources. At the risk of oversimplification, primary sources amount to original history and secondary sources are comment. Financial markets accommodate a similar distinction. Primary sources are objective market prices – a statement of fact (even if those same prices are distorted by central bank action, the price remains the price). Secondary sources are comment – a subjective statement of opinion (for example: editorial from a publication such as The Financial Times will report the price of gold and quickly add that it's a bubble). Given the 'drinking from a fire hose' nature of our web-enabled world, and the stubbornly finite number of hours in a day, the chances are that most consumers of financial news receive their commentary as secondary sources, filtered via somebody else's prejudices. Consumers of financial news are also surprised and prone to intellectual denial when they hear the suggestion from market participants that news typically ***follows*** the price, rather than the other way around.

Viewing the evolution of market dynamics primarily through primary sources – that is, via the evolution of securities prices – is handy at the best of times. It is particularly helpful in developing an impartial macro view when political deceit is trading at a supernormal premium. As Jean-Claude Juncker, prime minister of Luxembourg and president of the Euro Group, recently conceded to Der Spiegel, there are times when European politicians feel compelled to lie in order to "protect" the electorate. His defence, of course, is couched in Orwellian doublespeak:

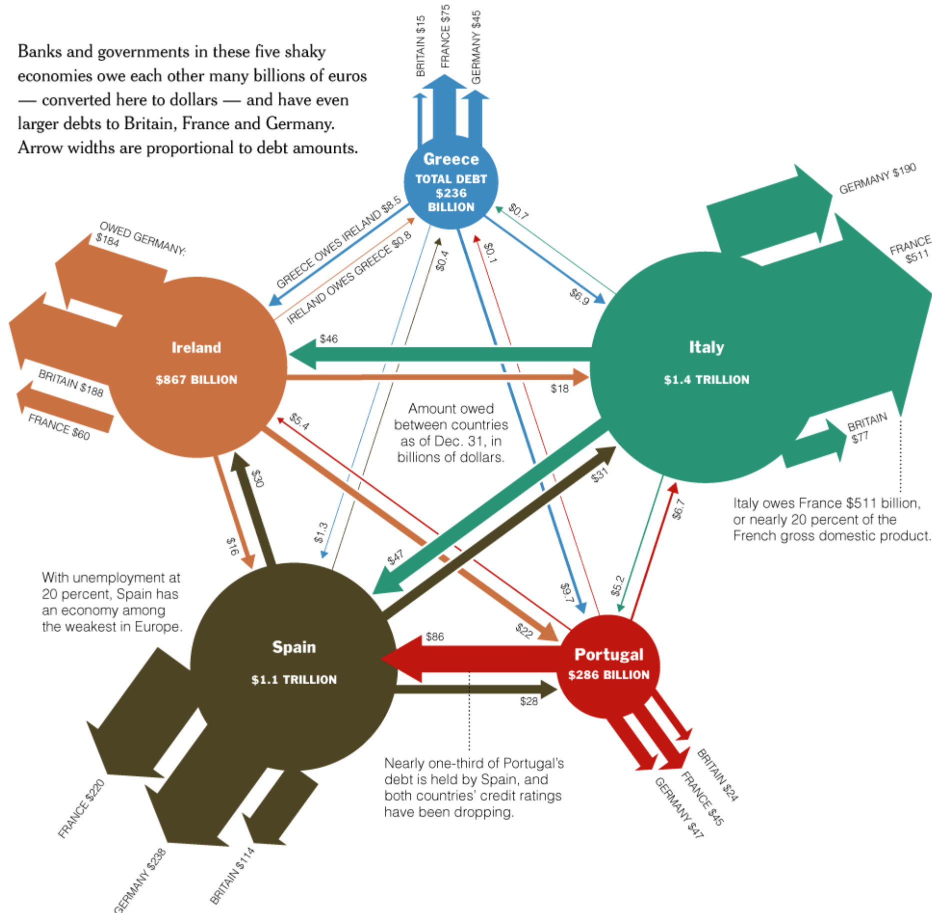
"In light of the nervousness of the financial markets, it is difficult for us to keep the public adequately and correctly informed all the time. This is regrettable.."

From the general to the specific. Members of the US administration routinely talk of their support for some mythical construct known as the 'strong dollar'. Official US policy is for this so far unseen 'strong dollar'. When other countries voiced their belief that QE2, the Fed's second round of quantitative easing, was in large part designed to weaken the US currency, the US authorities roundly denied the charge. They are for this supposed 'strong dollar'. The chart below shows the strength of the dollar over the last two centuries.

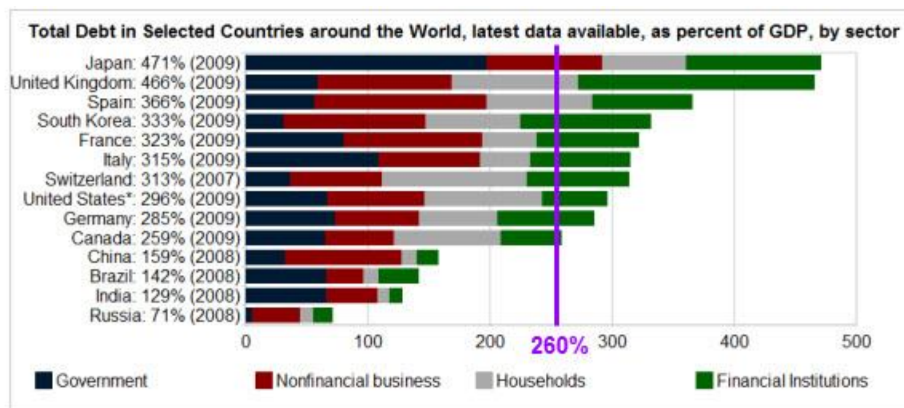


The decline is worse than shown, in that the graph doesn't take into account the history of the recent bail-outs and quantitative easing programmes. But the direction of the currency is clear, and it isn't up. In the interests of not frightening domestic readers, the path of Sterling isn't shown, but is comparatively worse. **Investment conclusion #1: hedge against ongoing currency degradation with precious metals, starting with gold.**

There are other reasons to use graphical representations of markets. Humans are hardwired to recognise patterns and to process images. The earliest forerunners of a written language, on the other hand, started to appear around 6,000 years ago – which in the context of our entire history as homo sapiens, is the blink of an eye. So images carry a lot more weight than text. Take, for example, the network of debt obligations between the nations of Europe, courtesy of the New York Times.



The graphic recalls the title of John Lanchaster's puckish study of Britain's banking and debt crisis: 'Whoops ! Why everyone owes everyone and no-one can pay'. Those who like their representations of international sovereign indebtedness in purer form can find an example below:



*** Including asset backed securities (ABS) US total debt would equal 350%-360%.** *Asset-backed securities are removed from McKinsey data since underlying mortgages and other loans are already included, so it would reflect a duplication within the data, according to McKinsey. Other data sources, including the FT, The Economist and Morgan Stanley, do include ABS in total debt figures.*

Investment conclusion #2: while it doesn't make sense to hold the debt of bankrupt countries (see above list for some of the more visible culprits), **it makes sense to own bonds issued by the most creditworthy sovereigns.** Particularly if Soc Gen's Albert Edwards is onto something with his deflationary 'Ice Age' prognostications. The Edwards thesis, in brief, is that in a cooling global economy, equities de-rate in isolation and versus government bonds, which re-rate in absolute terms.

These last two charts come via Chris Martenson and his excellent blog. A recent post, the self-explanatorily titled 'Death By Debt', makes the damning point that we are all trapped in an expanding credit system that has run into its terminal phase. We are used to living in a financial environment in which credit has grown exponentially. Global debt has been growing in a "nearly perfect" exponential fashion throughout the 1970s, the 1980s, the 1990s and the 2000s.

"In order for the 2010 decade to mirror, match, or in any way resemble the prior four decades, credit market debt will need to double again, from $52 trillion to $104 trillion..

Needless to say, this is not going to happen, although there would appear to be politicians, presidents, intransigent single currency blocs and bankers out there who believe it might.

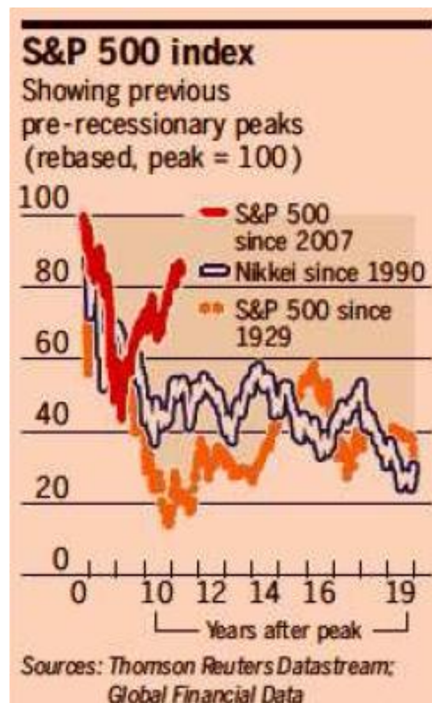
"It explains why Bernanke's $2 trillion has not created a spectacular party in anything other than a few select areas (banking, corporate profits) which were positioned to directly benefit from the money. It explains why things don't feel right, or the same, and why people are still feeling queasy about the state of the economy. It explains the massive disconnects between government pensions and promises, all developed and doled out during the prior four decades, cannot be met by current budget realities.

"Our entire system of money, and by extension our sense of entitlement and expectations of future growth, were formed during, and are utterly dependent on, exponential credit growth..

"What will happen when credit cannot grow exponentially ? ..Debts cannot be serviced, the weaker and more highly leveraged participants get clobbered first (Lehman, Greece, Las Vegas housing, etc.) and the dominoes topple from the outside in towards the centre. Money is dumped in, but traction is weak. What begins as a temporary programme of providing liquidity becomes a permanent programme of printing money needed in order for the system to merely function."

Note that Martenson uses the word 'function' as opposed to, say, 'thrive'. This is because the system has gone beyond the point of no return.

Fed chairman Bernanke during his June 7th address at the International Monetary Conference in Atlanta made no explicit mention of introducing QE3. He did concede that monetary policy rates would be kept at exceptionally low levels for an extended period, but we already knew that. Like a consistently spoilt child, the equity market didn't like what it heard and went into a sulk. But there is merit in looking beyond the short term to see the longer term trend. The Financial Times published the chart below in its weekend edition a week ago:



Its impact may not be immediately clear, so let us try and spell it out like crystal. After two previous historic busts, the S&P 500 (1929 to 1948) and the Nikkei 225 (1990 to, well, today) spent the subsequent two decades losing up to 80% of their value. In other words, after a colossal boom and a once-in-a-generation collapse, equity markets can and will disappoint all those taught to believe in stocks for the long run. The last several years (the bounce in the red line for the S&P 500) would seem to diverge from the historic path implied by the other two graphs. Perhaps the recovery of the last two years was a false one, bought by the trillions of stimulus poured into the market by a desperate Fed ? Time, as always, will tell. But if the comparison is a fair one, and we think it is, it is also time to reflect on what a sensible allocation to equities should be in the context of a balanced portfolio positioned primarily for capital preservation. The good news (if any) from the chart is that there is time for this reflection before deciding just how much, and how fast, to get out of Dodge.

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