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

4th July 2011

The Greek Miss

"The real problem of humanity is the following: we have paleolithic emotions; medieval institutions; and god-like technology."

- Dr. E.O. Wilson, biologist, Harvard University.

Greece has been an interesting diversion this past week, but the "successful" passage of austerity and reform bills through the Greek parliament changes nothing. The country is just as likely to default at some point in the near future, particularly if the mood of its rioters is any guide. All that the EU has bought, with its next tranche of bail-out money, is a bit of time. Procrastination comes very expensively these days. Here in the UK, the last week brought a more orderly degree of protest on the part of public sector workers who have failed to grasp the underlying reality: a generation of citizens aboard a bus of entitlement – to free healthcare, to wide-ranging benefits, and to universal and generous state pension provision – is shortly going to run headlong into a brick wall of disappointment and fiscal inevitability.

Kevin Phillips and Dr. Michael Hudson christened it the FIRE economy, indicating the extent to which the (United States') productive economy had become subservient to the forces of Finance, Insurance and Real Estate. As Eric Janszen points out in his masterful study, 'The post-catastrophe economy' (Penguin, 2010), the sandy foundations of the FIRE economy comprised debt-based economic growth. So what happens if the western economies have essentially allowed accumulated debts to grow to such a level that they can never realistically be paid back ? Well, we are about to find out, and investors in Greek bonds will probably find out ahead of anyone else.

The first commandment for the active investor should perhaps hinge not so much on knowing what to buy, but on knowing what to avoid. If one accepts the thesis that the western "developed" world is drowning in debt, then identifying the uglier bond markets in order to avoid them would seem like time well spent. (This then raises the question of whether it makes sense to allocate to bonds, as an asset class, at all. With official policy rates effectively at zero in the US and the UK, and both countries' national debts towering at eye-watering levels, suffice to say there are clearly more attractive markets elsewhere. But in the wider context of asset allocation, it is by no means clear, to us at least, that the near to medium term outlook is automatically inflationary. And here we should be very clear about defining our terms. Western financial markets may well be facing a future constrained by simultaneous monetary **inflation** and asset and credit **deflation** – the market outcome when central banking authorities are maintaining emergency monetary policies while the private sector desperately tries to steady the ship. At this point the investment decision then morphs from a purely credit decision to one that absorbs the impact of currencies as well. Not only do we want to lend our money – if at all – to those countries and entities best placed to pay it back, but we want to have our money denominated in those currencies which are most likely to retain their purchasing power in real terms in a world beset by dramatic deleveraging. The credit and currency decision then becomes one and the same. But since cash is precluded in purely investment terms courtesy of state-sanctioned inflationism and monetary policy theft from savers, its logical replacement in a balanced portfolio is high quality sovereign debt. Not an ideal replacement, given ongoing mark to market price volatility, but the best one we have.)

We can debate the merits of certain currencies (the Singapore dollar, say, or the Swiss franc, or the Norwegian krone – all of which are centred in countries with a significant surplus of foreign assets) versus the apparent demerits of other currencies (the dollar, or the euro, say, or the currencies of pretty much all of eastern Europe) but the purest and most logical response for the active investor is to remove political risk altogether and hold a currency that is outside the malignly manipulative inflationary power of any central bank. That currency, of course, is gold. As Chris Martenson writes, there are numerous reasons to own gold:

1. To protect against monetary recklessness.
2. As insulation against fiscal foolishness.
3. As insurance against the possibility of a major calamity in the banking / financial system.
4. For the embedded 'option value' that will pay out if and when gold is remonetized.

Outcome 4 is outside the scope of the discussion, at least for today – but reasons 1 to 3 are alive and well. As to the possible price range for Outcome 4..

"Here are some numbers: The total amount of 'official gold', or that held by central banks around the world, is 30,684 tonnes, or 987 million troy ounces (MOz). In 2008 the total amount of money stock in the world was roughly $60 trillion.

"If the world wanted 100% gold backing of all existing money, then the implied price for an ounce of gold is ($60T/987MOz)=$60,790 per troy ounce.

"Clearly that's a silly number (or is it ?), but even a 10% partial backing of money yields $6,000 per ounce. The point here is not to bandy about outlandish numbers, but merely to point out that unless a great deal of the world's money stock is destroyed somehow, or a lot more official gold is bought from the market and placed into official hands, backing even a fraction of the world's money supply by gold will result in a far higher number than today's c. $1,500/Oz."

Since there is not one example in the history of mankind of a purely paper-based currency surviving for anything more than a relatively short period, one feels bound to ask why gold retains such extraordinary power to animate the hostility of those with a touching faith in paper. Perhaps it amounts, like the cult of equity, to recency bias: most of the inhabitants of dealing rooms and fund management offices today, having spent the vast majority of their lives (since 1971) within a purely paper-based monetary system, know of no other form.

To return, briefly, to Greece, and what it represents. The prospect of EU and IMF money has charmed the markets, but it does nothing other than highlight the severity of the debt overhang facing the west. It is justifiable to fear sovereign debt and currency crises throughout Europe and the US over the coming months and years. Far from enjoying the sort of apparent surge towards democracy that the Arab Spring has been thought by some to articulate, in the words of Eric Janszen, western governments

"will respond to escalating domestic unrest with increasingly repressive surveillance and control";

the extent of the economic and political uncertainty facing investors should not be underestimated. Unfortunately, the human brain has not evolved well to appreciate or prepare for highly complex problems that may make themselves manifest over a considerable period of time. Instead our investment media report apparent progress (the Greek parliamentary votes) without acknowledging its fundamental irrelevance to the problems at hand (amongst which we would nominate: a huge democratic deficit and looming inter-generational warfare over benefits, state-sponsored inflationism and currency devaluation, global debt deflation, and peak energy). In the words of Stevie Smith,

"I was much further out than you thought

And not waving but drowning."

Tim Price
Director of Investment
PFP Wealth Management
4th July 2011.

Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com

Group homepage: http://www.pfpg.co.uk

Bloomberg homepage: PFPG <GO>