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# Clownish

"We're trying to save life on this planet as we know it today."

- Nancy Pelosi, Minority Leader of the US House of Representatives.

**Adventures in Capital Markets** Part 3,684. Depending on exactly what has transpired amongst the no talent ass clowns masquerading as US politicians this weekend, you may be reading this commentary in the warm, peachy glow of a freshly derisked market environment in which all is sweetness and magic moonbeams. Or you may be peering at this commentary in the guttering, eerie glow of a torch made from twigs, whilst fending off predatory marauders with a baseball bat.

**The House is in session**


(Source: American politics)

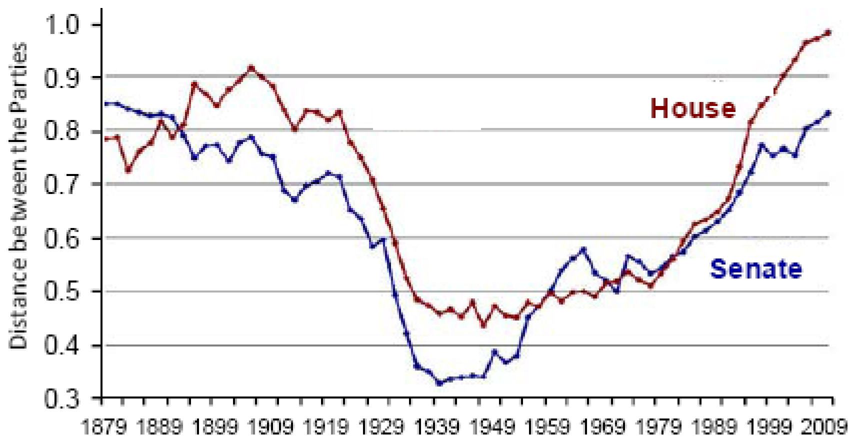
Coverage of the increasingly bizarre debt ceiling theatrics in the US has tended to focus on 'what if' scenarios based on the prospect of either a credit downgrade or an outright, albeit technical, default. Those investors not cradling US Treasury portfolios might rightly be asking just how the so-called Capital Asset Pricing Model (CAPM), which requires a theoretical risk-free asset to work, ever achieved such primacy in economic theory, and more to the point how US Treasury bonds ever managed to be regarded as risk-free assets in the first place.

The answer to the first question is that conventional economics is nonsense. In the words of P. J. O'Rourke, economics is an entire scientific discipline of not knowing what you're talking about. The answer to the second question is that conventional wisdom is not necessarily all that wise. Recent market convention has treated US Treasury bonds as the de facto risk-free benchmark because they comprise the largest and most liquid bond market in the world. Now pause for a second, and consider exactly what that means. Investors are (or at least have been) comfortable buying US Treasuries **because the US government is more indebted than anybody else**. Index benchmarking and index-hugging might have some sort of dubious merit in the context of equity markets, at least for the largely clueless managers who practise it, but it has none whatsoever in the context of debt markets, unless you are yourself a sovereign fund with too much money on your hands. For anyone else, US Treasuries, like most other western sovereign bond markets, are an expensively priced reflection of a bygone era of purely historic relevance amidst a global financial crisis brought about by too much of that self-same debt. Trying to justify ownership of dodgy government debt in a dodgy government debt crisis requires the sort of absurd reflexive contortions of thought that George Soros used to bore everybody writing about, and even he's now given up, at least when it comes to managing other people's money.

The 'look at me' posturing of America's politicians evidently reflects the degree of partisanship in the House and Senate, as JP Morgan's Michael Cembalest observes – partisanship that is now higher than at any time since the US Civil War:

**US party polarisation, 1879-2010**

Degree of partisanship as measured through analysis of all Congressional roll calls




Source: Keith T. Poole, University of California - San Diego, January 2011.

But the posturing will not have been completely in vain if it forces investors to adopt a slightly more mature and nuanced approach to investment risks. As it is, using US Treasuries as the de facto risk-free rate is like having Gary Glitter as the UN's Ambassador for Children.

On this side of the pond, euro zone investors have given their seal of approval to the second Greek bail-out by driving Italian and Spanish government bond yields higher. Welcoming Europe's concerted efforts to deliver financial stability, Moody's has placed Spain's Aa2 rating on review for downgrade. So different clowns, same circus. Trying to invest sensibly in this environment has gone beyond the existentially problematic to the downright surreal.

In a sense, of course, the latest twists in the global financial crisis simply represent the continued evaporation of public trust. First it was the bankers who were revealed to have been swimming naked, and fouling the water into the bargain. Now it is the politicians' turn. 'The Economist' has a neat turn of phrase to describe the problem: should investors buy the currency that might default, or the one that might disintegrate ? Our response, since we are not a sovereign wealth fund, is: neither.

For any saver frustrated at having to choose between losing money in real terms courtesy of inflation or having to put their capital at extra risk in the market in the pursuit of any kind of positive real return, please write to:

Mr. Ben Bernanke,
Chairman,
US Federal Reserve*,
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551
United States.

Disenchanted British savers can write to:

Sir Mervyn King,
Governor,
Bank of England,
Threadneedle Street,
London EC2R 8AH
United Kingdom.

You may wish to title your communication "Why as a saver should I be punished with punitively low interest rates on account of your institution's failure to control the banking sector ? Why should I then be doubly punished by the inflationary effects of this same monetary policy ?"

*The Federal Reserve is not actually a branch of the US government, as the name implies, but a private banking cartel – which goes some way to explaining why Wall Street has been the recipient of such extraordinary Federal Reserve largesse while the rest of Main Street can go whistle.

It is abundantly clear that any investment process founded on the risk-free primacy of US government debt is an investment process founded on sand. British media can report that UK bonds are "safer" than US Treasuries, but that is only like saying that pig excrement is objectively better than horse excrement. There is a conflagration burning through market assumptions about risk and return, and it is not finished yet. Unless and until politicians determinedly get to grips with the various mountains of debt blotting the investment landscape, rather than simply deferring difficult choices indefinitely, weak currencies and fragile credit markets will get weaker and progressively more fragile. Given that banks and government finances are inextricably linked in a perverted waltz of incompetence and leverage, it probably makes sense to avoid the grislier markets in each, altogether. We anticipate that by the time you read this, sufficient political heads Stateside will have been knocked together to cobble together some form of deal on the US debt ceiling, but stranger things have happened. Assuming a debt ceiling deal is struck, we then anticipate reloading into quality assets (including gold and silver) at lower levels. The core problem of too much debt in the system will not have been addressed, merely deferred, as always. In the words of Ludwig von Mises:

"The credit [debt] expansion boom is built on the sands of banknotes and deposits. It must collapse. If the credit expansion is not stopped in time, the boom turns into the crack-up boom; the flight into real values begins, and the whole monetary system founders. Continuous inflation (credit expansion) must finally end in the crack-up boom and the complete breakdown of the currency system."

Enjoy the ride. And in the words of Kevin Duffy, who like many Austrian investors anticipated the credit bubble and bust as far back as 2005, panic now and beat the rush.

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