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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Screwed

"..we in Britain are, to use a technical economic term, screwed. Economies across the whole world are struggling. Because nobody is spending money, even relatively blameless countries such as Germany, with low levels of debt and workforces who actually make things, are having a difficult time. Germany's economy is predicted to contract by 5.4 percent this year. A banker explained it like this: 'When your country's economy depends on people buying a car every three years, and they decide that they'll only buy a car every five years, you're f*****. Off a cliff.' So the German economy is f***** off a cliff. But it will recover, when people start buying cars again, and when it does, at least their underlying levels of debt are manageable. Something similar goes for Spain, where the ending of the property boom has caused a spike in unemployment to 17.4 percent, almost doubling in a year, or Ireland, which has contracted by a truly horrendous 8 percent and where people have gone from owning private helicopters to losing their homes in six months flat. All of these countries are in deep trouble. But there are four things you don't want to have, going into the current crisis. 1. You don't want to have had a boom based on a property bubble. 2. You don't want to have a consumer credit bubble. 3. You don't want to have an economy based on financial services. 4. You don't want your government to have just gone on a massive spending spree. We have all four of those things that you don't want."

- From 'It's Finished' by John Lanchester, published in the London Review of Books, May 2009.

There's apparently a Chinese proverb that says that a man who cannot smile should not open a shop. For this reason, from time to time, we try to leaven our commentary with some gallows humour, whistling as we jog, with increasing speed, past the churchyard. But our cousins in the financial media, free of the burdens of either regulation or the responsibility that comes with managing people's life savings, can operate with impunity, having set the doom-o-meter all the way up to eleven. Cue financial journalism's Silver Fox, the Daily Telegraph's Ambrose Evans-Pritchard, in his latest injection of gloom, 'When debt levels turn cancerous':

"Now we know where the tipping point lies. Debt becomes poisonous once it reaches 80% to 100% of GDP for governments, 90% of GDP for companies, and 85% of GDP for households. From then on, extra debt chokes growth."

The BIS link to the original paper was down when we last checked, but we can save you the bother of reading the original piece, not least since it contains this kind of thing:

$$\bar{g}_{i,t+1,t+k} = -\phi y_{i,t} + \beta' X_{i,t} + \lambda_{-} d_{i,t} I\left(d_{i,t} < \tau\right) + \lambda_{+} d_{i,t} I\left(d_{i,t} \geq \tau\right) + \mu_i + \gamma_t + \varepsilon_{i,t,t+k},$$

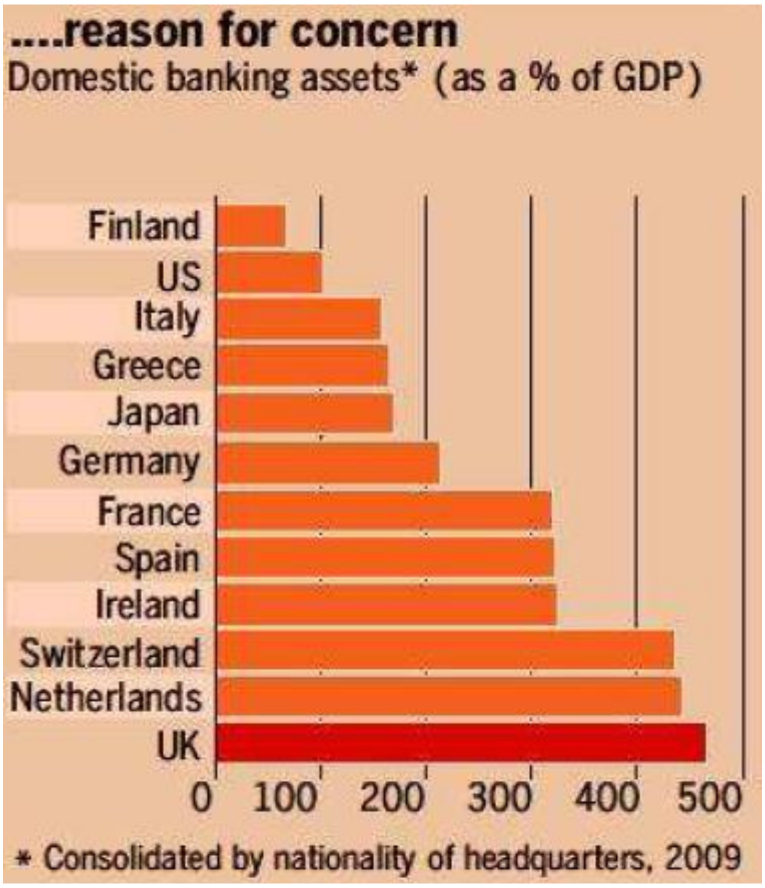
The conclusion, however, is very simple:

"In the end, the only way out is to increase saving."

See ? We've also saved you ploughing through 33 pages of PDF.

We note that the co-authors of economic treatises closely resemble the names of the more exotic estate agents or advertising agencies (the elusive BIS study is a Cecchetti, Mohanty and Zampolli co-production). But in other respects, the study doesn't really tell us anything we didn't already know. Debt can be good at moderate levels, but high levels are toxic for everyone involved.

If one were to cavil at the BIS study, it's that its charts are in fact insufficiently scary. But we can remedy that. The following chart of domestic banking assets as a percentage of GDP was published in last Wednesday's FT Lex column:



Sources: Thomson Reuters Datastream; ICB

As a reminder, a bank's assets are not its deposits, which count as liabilities, but rather its loans. Is there any chance, do we think, that UK banking sector loans, as an asset class, may not exactly be of unimpeachable quality ?

In John Lanchester's excellent original article, he pointed out that "we can have that very rare thing, a brief moment of sympathy for the banksters" because they are being given two totally incompatible goals. One is to rebuild their balance sheets and recapitalise. The other is to keep lending money.

"They're being told to save and to keep spending at the same time. It's not possible, and in the circumstances it's no mystery why banks are using every penny they can get, and calling in every loan they can: they're doing it in order to 'deleverage' and rebuild their capital as fast as possible."

The banks have an impossible task. Having bailed them out once, governments, not least our own, have a similarly impossible task. On the one hand, they have become the spenders of last resort, given that the private sector has gone into full-blown deleveraging mode. But on the other hand, they have also twigged that as and when markets lose confidence in their ongoing ability to borrow from the bond markets, the jig is up. So the government has to steer a very precarious path between being emergency spender of last resort and maintaining a commitment to austerity without plunging the economy into a depression. To paraphrase from the original Irish "joke", if you're planning to travel to recovery, you wouldn't want to start from here.

Unlike for our cousins in the financial media, look-at-me wailing and 'o me miserum !' in isolation are not sufficient. We need to have a plan. Happily, we think we have one:

1) For as long as deflationary forces are working their insidious magic upon credit markets, there is merit in holding objectively high quality sovereign, quasi-sovereign and corporate debt. When one can hold such debt with a yield of roughly 6% or more, it may represent the bargain of a lifetime, given that cash rates sit at approximately zero;
2) For as long as central bankers, equity hucksters and other QEtards bay for further stimulus, the stock market will be prone to short-term, super-heated relief rallies. But rather than track the market, we are content to try and cherry-pick defensive businesses with objectively high quality balance sheets in sectors we prefer. (Our proxy for "objectively high quality balance sheets" ? – The Altman Z Score.) That there will be volatility, perhaps extreme price volatility, from time to time is simply part of the landscape, and we should all get used to it. Some of these lurches downward, though not all of them, will prove to be buying opportunities on a selective basis.
3) Actively managed funds that pursue non-discretionary systematic trend-following strategies. The typical historic correlation of such vehicles to the stock market ? Roughly zero.
4) Real assets, most notably the monetary metals, gold and silver, and related investments.
5) Adjust, according to taste.

We very much doubt whether 'the answer' to the investment, financial and economic challenges of our time can be boiled down to one essential solution. Rather, it would seem that a market environment unlike any that anyone has previously experienced requires an unusually high degree of pragmatism, allied with an open mind. If you believe, for example, that gold is in some kind of a bubble, the chances are that you do not appreciate the downside risks always and now acutely inherent in paper assets. The following letter from Mr John Read, for example, appeared in Friday's FT:

"..Surely the problem is not gold but what looks like a potentially irretrievable breakdown of trust in the ability of western governments to maintain the value of our currencies, particularly as their profligacy over several decades, allied with their continuing inability to act effectively, suggests they may be constitutionally unable to provide a solution to the financial crisis they have helped to cause ?

"The western governments could engineer a collapse in the price of gold at any time of their choosing by selling their enormous gold holdings, but even the UK is still holding a large amount of it, notwithstanding the sale of a similar quantity at a far lower price. Perhaps they could be looking at it as a desirable asset to have ?

"Arguably gold has to be a safer bet than the pound sterling, which in this writer's lifetime (76 years) has lost about 98 percent of its value !"

And we haven't forgotten our hypothetical Chinese shop owner. On the one hand, if credit default swap and share prices are any judge, the banks are in trouble again. But on the other hand, here is a picture of a kitten:

A kitten

Source: Find a kitten

Tim Price
Director of Investment
PFP Wealth Management
5th September 2011.

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

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

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