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The final countdown

"Under the circumstances, discussions with Greece and the official sector are paused for reflection on the benefits of a voluntary approach." Debt talks "have not produced a constructive response."

- The Institute of International Finance, January 13 2012.

"The war situation has developed not necessarily to Japan's advantage.."

- Japanese Emperor Hirohito after the atomic bombing of Hiroshima and Nagasaki, announcing Japan's surrender to the Allies.

There is a terrible hubris at the heart of mankind. Like every other living thing on the planet we are products of nature, but we consider ourselves to be well above it. We are beset by regular reminders of our vulnerability, but quickly dismiss them off-handedly to a spiritual plane, calling them 'acts of God' as if to show that we could never have prevented them. In a significant essay for Foreign Affairs, 'The Black Swan of Cairo', Nassim Taleb shows how the efforts of our authorities to suppress volatility actually end up making the world less predictable and more dangerous.

"Although the stated intention of political leaders and economic policymakers is to stabilize the system by inhibiting fluctuations, the result tends to be the opposite. These artificially constrained systems become prone to "Black Swans" – that is, they become extremely vulnerable to large-scale events that lie far from the statistical norm and were largely unpredictable to a given set of observers."

There is an analogy from the natural world. In the 1960s and 1970s, mid-western American states fell victim to scores of wildfires. Constant interventions by the US Forest Service appeared to have little positive impact – if anything, the problems seemed to worsen. Over time, foresters came to appreciate that fires were a normal and healthy element of the forest ecosystem. By continually suppressing small fires, they were unwittingly creating the conditions for larger and less containable wildfires in the future. Naturally occurring fires are necessary to remove old forest cover, underbrush and debris. If they are suppressed, the inevitable fire to come has a far greater store of latent fuel at its disposal.

Economist Murray Rothbard jangled the sensibilities of the Keynesians when he wrote his classic study, 'America's Great Depression':

"If government wishes to see a depression ended as quickly as possible, and the economy returned to normal prosperity, what course should it adopt ? The first and clearest injunction is: ***don't interfere with the market's adjustment process***. The more the government intervenes to delay the market's adjustment, the longer and more gruelling the depression will be, and the more difficult will be the road to complete recovery."

But politicians must be seen to be doing something – like encouraging the construction of a £33 billion white elephant rail link in the middle of an austerity recession.

Not interfering with the market's adjustment process is simply allowing Schumpeterian 'creative destruction' to operate, and cleanse the forest. But that process is anathema to well-compensated entrenched interests that suckle from the teat of the State. Banks, for example. So while 'laissez faire' would accelerate any banking crisis and shorten the resultant economic contraction, it would reveal the identity of too many naked swimmers when the tide retreats. Instead, courtesy of highly paid lobbyists, we get a long drawn out depression. The example of Japan's zombie banks from the 1990s is still fresh, but ignored in the west.

Rothbard identified the ways in which government can hobble the adjustment process:

1. *Prevent or delay liquidation*. Lend money to shaky businesses, call on banks to lend further..
2. *Inflate further*. Further inflation blocks the necessary fall in prices, thus delaying adjustment and prolonging depression. Further credit expansion creates more malinvestments which, in their turn, will have to be liquidated in some later depression. A government's "easy money" policy prevents the market's return to the necessary high interest rates.
3. *Keep wage rates up*..
4. *Keep prices up*..
5. *Stimulate consumption and discourage saving*.. more saving and less consumption would speed recovery; more consumption and less saving aggravate the shortage of saved capital even further.
6. *Subsidize unemployment*. Any subsidization of unemployment (via unemployment "insurance", relief, etc.) will prolong unemployment indefinitely, and delay the shift of workers to the fields where jobs are available.

An iatrogenic illness is one caused by the doctor himself. The economies of the west now face policy measures of the sort highlighted by Rothbard that are stated to be in our interests, but which are more likely to do harm to the patient and prolong the recession.

Taleb uses the example of the turkey before Thanksgiving. The turkey is fed for 1,000 days and every days seems to reaffirm the farmer's generosity of spirit. Until the last day, when the turkey's confidence and contentment is at its maximum. The "turkey problem" occurs when "a naïve analysis of stability is derived from the absence of past variations". To put it another way, the US property market cannot decline because it hasn't declined in living memory. As Taleb puts it, as humans we inhabit two systems simultaneously: the linear and the complex. The linear is predictable and permits the use of mathematical tools of high predictive value. Complex systems, on the other hand, are marked by an absence of visible causal links between their elements, "masking a high degree of interdependence and extremely low predictability". They also incorporate non-linear elements often called "tipping points". One reason for the severity of the financial crisis, and the losses incurred by banks, is that bankers and financial analysts were using linear tools in a non-linear, highly complex environment otherwise known as the financial markets. The models didn't work.

The problem we face now as investors will end up being existential for some banking institutions and sovereigns. Our (uncontentious) core thesis is that throughout the west, more debt has been accumulated over the past four decades than can ever be paid back. The question, effectively to be determined on a case-by-case basis, is whether bondholders are handed outright default (which looks increasingly like the case to come in Greece) or whether the authorities, in their understandable but misguided attempts to keep the show on the road, resort to a policy of inflation that could at some point easily spiral out of control. As Rothbard wrote,

"The longer the inflationary boom continues, the more painful and severe will be the necessary adjustment process.. the boom cannot continue indefinitely, because eventually the public awakens to the governmental policy of permanent inflation, and flees from money into goods, making its purchases while [the currency] is worth more than it will be in future. The result will be a "runaway" or hyperinflation, so familiar to history, and particularly to the modern world. Hyperinflation, on any count, is far worse than any depression: it destroys the currency – the lifeblood of the economy; it ruins and shatters the middle class and all "fixed income groups"; it wreaks havoc unbounded.. To avoid such a calamity, then, credit expansion must stop sometime, and this will bring a depression into being."

It may be a new year, but we are beset by the same problems that have been recurring since the crisis began. In most cases, those problems have worsened. One of the few improvements has been in the recapitalisation of Anglo-Saxon banks, but continental European banks seem acutely vulnerable to the potential outcome of a disorderly sovereign default. Since the problems are the same, so are our preferred solutions: a specific focus on only the most creditworthy sovereign and quasi-sovereign debt (where it offers a positive real return); a specific focus on only the most defensive and internationally diversified equities; genuinely uncorrelated investments; and exposure to objectively the highest quality currencies, namely precious metals.

Euro zone politicians and policy makers have had plenty of time to come to terms with the continent's problems, and continue to show no willingness to grasp admittedly difficult nettles. It is symptomatic of the balkanised and adversarial nature of politics in the euro zone (a unified body that exists in theory but barely in fact) that Christian Noyer, chairman of the French central bank, anticipated France's credit downgrade by suggesting that Britain should be downgraded first. As the Hildebrand scandal also revealed, most of Europe's central bankers are not fit to sweep the streets. And still time is running out. Readers of a certain age will recall a late 1980s 'big hair' rock anthem called 'The Final Countdown'. It was released by essentially a one-hit wonder band. Its name was ***Europe***.

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