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A kind of magic

"SIR – What is the best solution to Europe's banking crisis ?
Greece-proof paper."

- Letter to The Economist from Celia Turner, London.

There were plenty of reminders of the gravity of the underlying situation during the past week, for anyone that cared to look. The financial markets had already moved on from paying any attention to the €100 billion of 'mystery money' earlier pledged to support the Spanish banking system. The euro zone patient remained in intensive care with no obvious palliative remedies in sight. On Thursday, ratings agency Moody's downgraded 15 global banks. And on Friday, in a rather horrible coincidence, account holders at NatWest, RBS and Ulster Bank were unable to withdraw money from their accounts. Those banks may not have run out of cash, but the failure of their computer systems might have been better timed. In the UK, popular attention was focused on the tax affairs of a few high profile entertainers. This was a classic piece of misdirection on the part of a cynical government (once again siding with a fickle media with questionable motives) whose own fiscal affairs are out of control. The sad reality is that across the economies of much of the West, government finances and the banking sector that has helped worsen them are hopelessly broken. The markets and financial media oscillate between what is fatuously described as 'risk on' euphoria, boosted by the delivery or expectation of central bank money printing, and 'risk off' despair, as the underlying health of the economy and financial system inevitably reveals itself. In this environment optimism itself is mostly poisonous, in that it delays the hard action and genuinely tough choices that will ultimately be required. Tullett Prebon's Terry Smith is surely right: there is no solution "in the sense of a path which does not involve considerable hardship".

One of the UK government's most baffling achievements to date has been in persuading the country that it soldiers on under a burden of austerity. That austerity has in fact yet to begin. As Hinde Capital point out, in a 32 page indictment of UK national solvency entitled 'Eyes Wide Shut',

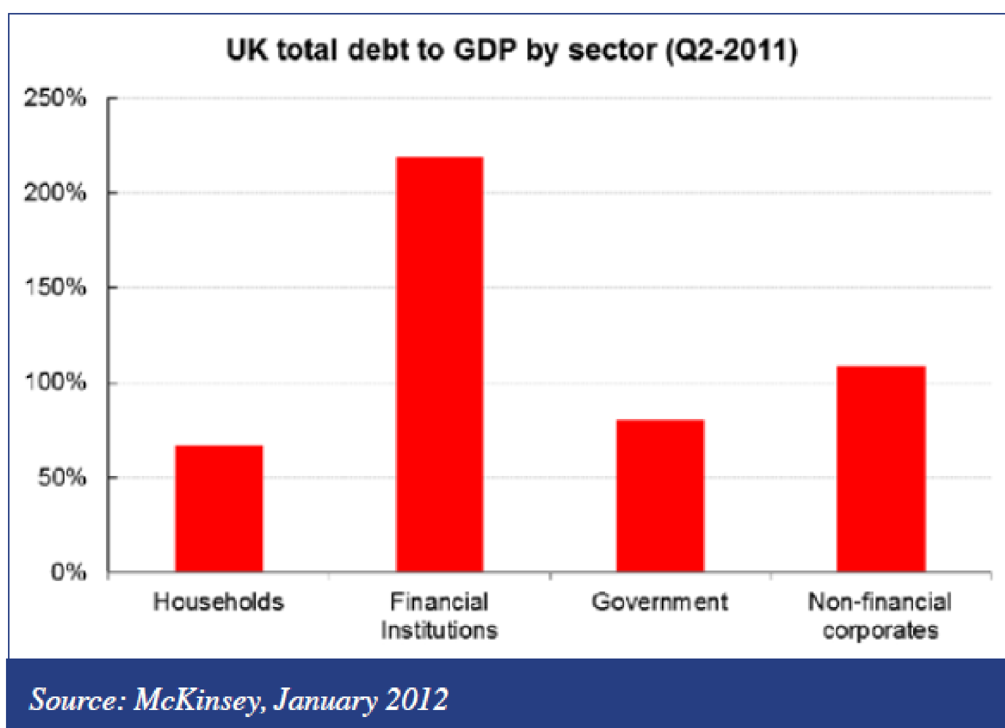
"There are no signs the UK is on the mend. The UK debt profile both in the public and private sector is continuing to grow as a share of GDP.. Growth is worryingly absent and so the UK has structural tax problems."

Cue one of the country's most famous comedians being wheeled out to lambast Jimmy Carr.

"[And] as each year passes, not only does the cyclical fiscal deficit grow worse but the structural primary deficit threatens to rise exponentially. Public sector finances are not rebalancing."

The UK government bond market has so far survived the deterioration in our national economic health because investors have difficulty in discriminating between nominal and real returns, and also because the Bank of England can print money at will (thus widening the wedge between the nominal and the real) to ensure that its debt liabilities are serviced. To call Gilts "riskless" today is like describing the last section of the sinking Titanic that remains above the waves "safe". Gilt buyers are sacrificing real returns in the cause of what they believe will be capital preservation. At some point they are going to be hugely disappointed as they are separated from their wealth. There are grave implications for the insurance and pension fund industry inasmuch as they also participate in this gigantic orgy of money illusion and duly jeopardise the savings of their clients. There are also grave implications for the purchasing power of sterling, which is one reason why we favour harder Asian currencies over rapidly depreciating western ones.

And then there are bonds and there are bonds. UK government indebtedness is severe enough, but that ignores the liabilities of the ever-popular financial sector:



Source: McKinsey, January 2012

More so than many other ailing western economies, in the UK the banking sector and the government debt market have become essentially fused. Since we have been talking about the illusionist's strategies to which our politicians are resorting, they will soon have to get used to another magical effect: the disappearance of money consistent with deposit withdrawals and the paydown of debts. Further quantitative easing to compensate for this debt deflation looks assured. (On both sides of the Atlantic.) Faced with what seems to be a racing certainty in the form of further money creation, gold at current levels looks like a terrific purchase.

Bond fund manager Bill Gross has also deployed the vocabulary of the illusionist to describe the desperate policies of the central banks. Risk markets, he has said, are vulnerable as the "monetary bag of tricks empties". How long until the next downwave in financial asset prices is, as always, impossible to predict. Confidence in the financial system does not operate in a linear manner. As recent bank runs have shown, confidence in the system lasts until it simply doesn't any more. But with unexploded ordinance littering the global financial landscape, prudence and conservative strategies seem more than usually appropriate. Our own asset allocation pillars: objectively

creditworthy sovereign debt well away from the usual suspects, in well-managed and / or resource-rich economies (hint: many of them are Asian); broadly defensive stocks in broadly defensive sectors, or the shares of businesses whose valuations offer some protection against a market wide panic sell-off; uncorrelated actively managed vehicles (systematic trend-following funds); and real assets, notably the monetary metals. Longstanding readers will appreciate that this asset allocation approach has not changed at all since the financial crisis began. This largely reflects our view that nothing substantive has changed, unless for the worse. Since our self-selected mandate is capital preservation in absolute terms, we can afford to be highly selective when it comes to the selection of financial instruments. Quasi- or explicit index-trackers – whether in debt or equity markets – have no such leeway, so they are likely to go down with the ship when it hits the rocks.

A last observation on the highly contentious topic of tax. Avoidance is legal; evasion is not. If politicians have a problem with schemes judged to be legal, the onus is on them to move to change the law to their satisfaction, and not on the supposedly "immoral" tax "cheat" to behave "responsibly". Our last words on the matter will be those of Lord Clyde:

"No man in the country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or property as to enable the Inland Revenue to put the largest possible shovel in his stores. The Inland Revenue is not slow, and quite rightly, to take every advantage which is open to it under the Taxing Statutes for the purposes of depleting the taxpayer's pocket. And the taxpayer is in like manner entitled to be astute to prevent, as far as he honestly can, the depletion of his means by the Inland Revenue."

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