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The greatest trick

"I believe in an America where millions of Americans believe in an America that's the America millions of Americans believe in. That's the America I love."

- US Presidential Candidate Mitt Romney.

Never try to teach a pig to sing, advised Robert Heinlein. It wastes your time and it annoys the pig. We try to shy away from overmuch coverage of politics in this commentary for similar reasons – it's probably a waste of time, and many readers hate it. But trying to avoid politics in the financial world is easier said than done. Five years of enduring crisis have gifted more and more power both to the politicians whose easy spending helped cause the crisis, and to their appointees in central banks who have run out of conventional policy options and are now busily stacking up unintended but nevertheless vast and intractable problems for the future. Market prices are no longer determined by the considered assessment of independent investors acting rationally (if indeed they ever were), but simply by expectations of further monetary stimulus. So far, those expectations have not been disappointed. The Fed, the ECB and lately even the BoJ have gone "all-in" in their fight to ensure that after a grotesque explosion in credit, insolvent governments and private sector banks will be defended to the very last taxpayer.

Mitt Romney was widely derided as having "gaffed" when he spoke of the now infamous 47%

"who are with [the President], who are dependent upon government, who believe that they are victims, who believe the government has a responsibility to care for them, who believe that they are entitled to healthcare, to food, to housing, to you-name-it. That that's an entitlement. And the government should give it to them."

Romney may have been "inelegant" in his choice of words. But at least he had the guts to voice what many silent millions must surely be thinking across the ailing western economies. It takes many things to bring errant government finances under control. Simply pledging to squeeze the rich (and casually conflating tax avoidance – which is legal – with tax evasion – which isn't) is an aggravating diversion for wealthier voters. As any hole-digger knows, the very first policy response on recognition of the hole should be to stop digging. For a heavily indebted government, the equivalent of stopping digging is cutting spending. And yet we have a coalition government allegedly focused on austerity and deficit reduction which is content, for example, to keep giving hundreds of millions of pounds of development aid to wealthy countries.

Just as government-led austerity is something of a myth in the UK, deleveraging would seem to be a myth of comparable standing in the US. The consistently excellent Doug Noland points out the absurdity of the US deleveraging myth:

- US non-financial credit market debt grew by 5% in the second quarter, its strongest expansion since Q4 2008;
- Corporate credit market borrowing grew by 6.9%;
- Consumer credit grew by 6.2%;
- Federal borrowing grew by 10.9%;
- While household debt has declined by $800 billion since the end of 2007, to $13.5 trillion, federal debt has expanded by more than seven times that decline: total non-financial debt ended Q2 at a record $38.9 trillion, having expanded by $6.5 trillion over 16 quarters;
- As a percentage of GDP, total non-financial debt has grown from 124% of GDP in June 2008 to 249% of GDP as at the end of the second quarter.

As Noland suggests, a genuine deleveraging would see price levels and market-based incentives adjust across the economy in a manner that would support business investment. Genuine deleveraging would see a change in economic emphasis from credit-fuelled consumption towards savings and productive investment. Central bankers, on the other hand, having driven interest rates to the zero bound, seem determined to destroy savers. Genuine deleveraging would see a meaningful reduction in non-productive debt. Genuine deleveraging would see market prices determined by fundamental forces and not by government intervention, manipulation and inflationism. Instead, we get a profound form of 'mission creep' by central banks like the Fed, which in the words of veteran analyst Jim Grant has evolved well beyond its origins as a lender of last resort and not much else, and now is fully engaged in the business

"of steering, guiding, directing, manipulating the economy, financial markets, the yield curve; it manipulates and pegs interest rates - it is all over the joint, doing what so signally failed in the old eastern bloc."

And so it is that the government agencies that have given themselves the mission of economic oversight are now working to destroy the very same economies they are nominally tasked with protecting. It is a wholly specious argument to suggest that the creation of trillions of dollars / pounds / euros / yen out of thin air will not ultimately be inflationary; like saying that storing an infinite amount of tinder next to an open flame does not constitute a fire hazard. Admittedly, the explicit inflationary impact of historically unmatched monetary stimulus will not be fully visible until those trillions are circulating in the economy in private exchanges between buyers and sellers – rather than squatting ineffectively in insolvent banks' reserves. But financial markets are nothing if not capable of anticipating future trends. Investors, traders, speculators – call them what you will – are already weighing up the probability of a reduction in future purchasing power driven by open-ended commitments to money printing today, and the prices of alternative money such as gold and silver, as denominated in unbacked fiat currency, are already responding.

Financial repression, of course, is all about wealth transfer. Inflationism is the textbook response to a crisis of too much debt (even if you were the over-borrowed entity that triggered the crisis in the first place). Many constituents (pensioners in traditional schemes and on fixed incomes, annuity holders, depositors) will be more or less powerless to avoid the looming inflationary wave. But it is not too late for savers and investors less constrained by circumstance. Brent Johnson of Santiago Capital has a nice line in telling it how it is. With one eye on 'The Usual Suspects' he indicates that "the greatest trick central bankers ever pulled was convincing the world that they work for the public and not for the banks."

His advice, which we fully endorse, is to move away from the realm of paper assets and towards the world of real ones. Anticipating that inflationary tsunami is not a precise science because market confidence in intangible paper currency does not persist in a linear fashion. It lasts until it doesn't last any more, and then it runs the risk of shattering instantaneously, along with faith in most G7 government debt. Like Hemingway's bankrupt we go broke slowly, and then all at once. But one of the most grotesque ironies of our time is that the asset class that is objectively the least attractive as well as the proximate cause of the world's financial problems – western market government debt – is also the most expensive. Just because sheep-like bond fund managers are providing a real time lesson in the perils of agency risk does not mean we have to follow them down the primrose path. Cash, most forms of bonds, and fixed annuities all look like poor prospects for the years ahead. Productive real estate, defensive equities of businesses with pricing power, gold and silver all look like better alternatives.

The last Fed chairman with the guts to do the right thing for the economy rather than just its banks, Paul Volcker, has rightly observed that "monetary policy is about as easy as it can get". Another round of QE "will fail to fix the problem". That is in part because the Fed, along with its international peer group, now ***is*** the problem. The sooner voters come to appreciate the dangers inherent in modern central banking and its unlimited powers to manipulate the financial system, the better. Are there any politicians out there who can rise to the challenge ?

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