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A Greek Tragedy

"In money management what sells is illusion of certainty. The truth (i.e. we don't know much) is a more difficult sale, but a better investment."

- Tweet from Piet Viljoen of RE: CM asset managers.

"A woman was trying to read
If deposits were still guaranteed
If her bank would consign
To Frankfurt am Main
Or Cyprus would have to secede."

- Tweet from Dr. Goose

"..a quite outstanding week's work by the Troika [ECB, EC, IMF]. Take a moment to realise the scale of what's been done here. No human agency has achieved so much economic destruction in such a short time without the use of weapons."

- Pawel Morski, 'Cyprus: the operation was a success. Shame the patient died'.

"Alright, people just need to chill. Cyprus is a tiny country. To put things in perspective, its GDP is roughly the size of.. Lehman."

- Tweet from Jesse Livermore.

Like Lehman Brothers before it, Cyprus may well come to be seen not so much as the cause of further crisis but as yet another symptom of the 'long emergency' that continues to suffocate the western economies. We would describe this emergency as, fundamentally, an inevitable crisis triggered by an unsustainable explosion of credit. No progress or improvement has been or will be possible in the underlying condition because both the banking sector that collectively lost its mind and the governments that permitted it to are fatally dysfunctional and equally bankrupt, literally ***and*** morally. Western banks and western governments are now like Macbeth's

"..two spent swimmers, that do cling together
And choke their art."

The prime minister of Luxembourg, Jean-Claude Juncker, has provided two clear insights into the world of deceit that the modern politician inhabits:

"We all know what to do, we just don't know how to get re-elected after we have done it."

And,

"When it becomes serious, you have to lie."

This is what we now have by way of parliamentary democracy: a self-serving elite who cannot be trusted, operating to a timetable defined by, and limited to, the electoral cycle.

This democratic deficit is possibly more severely damaging than the supposedly intractable fiscal one that lies beneath it. One of the most outstanding discussions of these twin deficits was made by John Lanchester in May 2009. It's a long piece but well worth the effort. Because it conveys the genesis and resultant scale of the banking horror story in terms that a layperson can understand, it may be one of the standout accounts of our 'long emergency'. As Lanchester points out, western governments for five years now have been going to tremendous, Basil Fawltyish lengths to avoid taking insolvent banks into public ownership. Whatever emerges from the disaster that is now the Cypriot economy (with euro zone policy making nicely described by Dan Davies as "Laurel and Hardy carry a piano upstairs"), Cyprus has reminded us of a couple of awkward truths that most politicians and bankers would prefer to keep off balance sheet:

1) A deposit in a bank is not a riskless form of saving. We may not see eye to eye with the FT's Martin Wolf on many aspects of modern economics and central banking in particular, but he described banks well last week: "Banks are not vaults. They are thinly capitalised asset managers that make a promise – to return depositors' money on demand and at par – that cannot always be kept without the assistance of a solvent state."

2) When states become insolvent, the piper must ultimately be paid. Fatally embarrassing insolvency is not a problem that can be perpetually or painlessly deferred.

Cyprus matters not because of the size of its economy or even because it is, for the time being at least, a member of the euro zone. It matters because the inept handling of its banking crisis last week threw one facet of modern banking into sharp relief: if a deposit guarantee scheme is seen to be fraudulent or sufficiently fragile to be easily smashed by politicians, then confidence in banks per se, and at a wider level confidence in unbacked paper currency itself, will be vulnerable to an unpredictable run. CLSA strategist and financial market historian Russell Napier writes as follows:

"..the Euro is the progeny of political desire and is succoured by the political elite. If, however, the people of the system believe that the Euro's sustenance necessitates the use of arbitrary power resulting in unequal treatment [i.e. the abandoning of bank deposit insurance for retail savers] then they will conclude that the Euro system is not worth having. The loss of democracy and the rule of law will outweigh whatever economic benefits Euro membership may bring. The citizens of the PIIGS [Portugal, Italy, Ireland, Greece and Spain] have shown incredible resilience to the economic sacrifices they have been asked to make, but will they be as resilient to the loss of democracy which the creation of the Euro necessitates and which the Cypriot bank levy clearly illustrates ? ..the bending of the rule of law to prevent its economic collapse brings arbitrary and unfair outcomes which peoples have always rebelled against. There will clearly be short term consequences from the sequestration in Cyprus but the key impact will be long term as the citizens of the Euro, like the citizens of the Soviet Union or the American colonies before them, eventually reject the sacrifice of political rights necessary to support the system. ***When the history books are written, the Brussels-imposed sequestration in Cyprus will be seen as the tipping point when the citizens of the Euro system realised that the socio-political sacrifice needed to sustain a single currency was just too great***." [Emphasis ours.]

As the earlier quotation from Piet Viljoen makes clear, the 'illusion of certainty', in asset management, sells. We have taken great pains to point out our own limitations in predicting the future, and in turn to establish an asset management process that reduces dependency on those predictions, by means of rigorous asset class diversification (which we continue to maintain represents the last free lunch in finance). During a debt crisis it may seem perverse to hold debt instruments at all. But in our defence we hold bonds of unimpeachable credit quality issued by objectively creditworthy sovereign and quasi-sovereign borrowers. That those bonds yield more than bonds issued by heavily indebted / insolvent western economies naturally adds to their attractiveness. We also hold broadly defensive and otherwise attractively valued listed equities – but because we cannot foresee the future, we have a natural interest in protecting client portfolios against market shocks, so our equity exposure is always likely to be more moderate than most of our 'boy racer' peers with their 'here today, gone tomorrow' herd-like and casual attitude towards risk. We hold uncorrelated managed funds. And in light of current events in Cyprus, we have a particular interest in holding tangible, non-financial, currency hedges like gold and silver, which unlike euro zone bonds offer no credit or counterparty risk whatsoever. Actions have consequences. Cyprus may end up being a storm in a teacup. Like Russell Napier, we fear it may well be the start of something altogether more sinister. If you have yet to consider the sanctity, stability, 'store of value-ness' and true safety of the paper currency you hold within the banking system, now might be a good time to start.

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