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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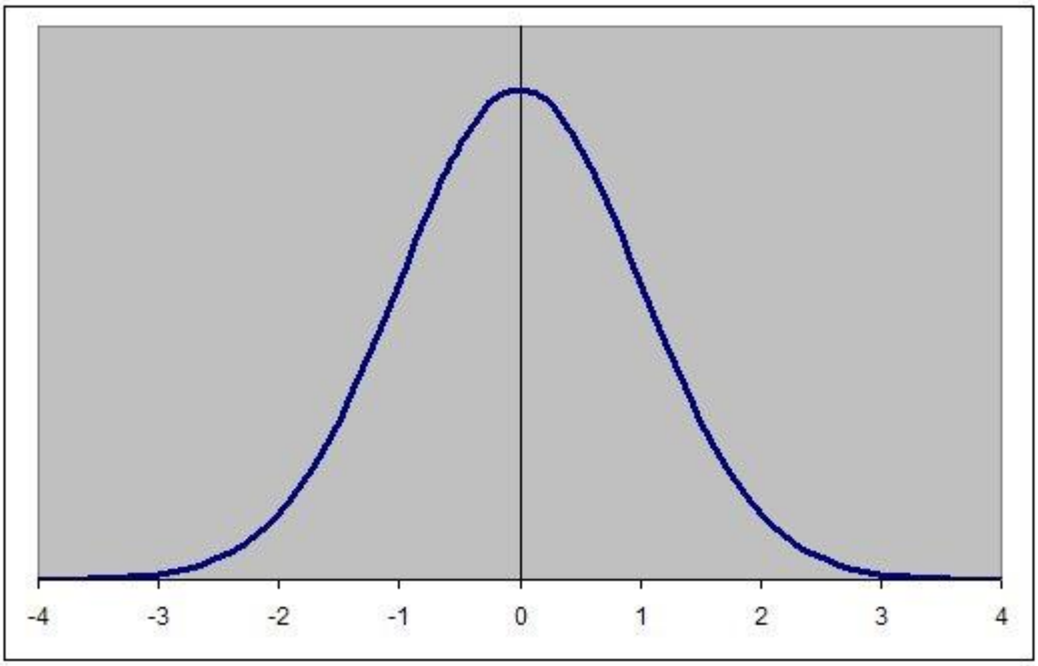
Do you have a licence for your Minsky ?

(With thanks to Matt and The Daily Telegraph)

Wikipedia defines a ***Minsky moment*** as the point in the credit cycle when investors start to incur cash flow problems due to the growing debt load they have acquired in order to finance speculative investments. At this point in the cycle, a major sell-off begins as counterparties start to withdraw from the market, leading to a sudden and precipitous collapse in asset prices, accompanied by a sharp drop in liquidity. Economist Hyman Minsky argued during his lifetime that markets were inherently unstable and that prolonged stability (a bull market, if you will) always culminated in a larger collapse. This has something in common with Mandelbrot's view of market instability, namely that the idea that market prices and volatility are normally distributed – essentially, held within the classic, orderly 'bell curve' of standard distribution – is a dangerous myth. A nice metaphor for market instability in this context is a sand pile slowly growing on a table. As each individual grain of sand is dropped onto the pile, the sand pile grows in a more or less orderly fashion. But at some point, just one extra grain of sand will cause the pile to collapse upon itself. But judging in advance precisely which individual sand grain will cause the tipping point may be impossible. The natural order of markets, in short, may actually be closer to chaos than we think.

Chaos has this eerie ability to pop up seemingly from nowhere. The drilling rig seems to be functioning properly, and then it suddenly explodes. It is probably too early to state with certainty exactly why US markets dropped by 10% on Thursday, albeit they were quick to recover most of their losses. (Indeed the quest for certainty itself may be wholly illusory.) Early potential culprits were identified as fat-fingered dealers or high-frequency algorithmic trading systems, or both. It seems a justifiable question to ask why banks – if they were involved – should continue to have the privilege to distort financial markets to this degree, or why high-frequency trading systems should be allowed to squat upon the infrastructure of the equity market like some kind of hugely manipulative but frankly irrelevant parasite. It is as if financial markets were administered and regulated (nice one !) by the state solely for the purpose of institutional speculation. Other than the pursuit of the profit motive, where is the social utility ? But since the causes of the 1987 Crash continue to be debated (although the inherently flawed concept of portfolio insurance is widely deemed responsible), it is probably naive to expect to come to any definitive conclusion about last week's 'Black Thursday' any time soon.

This is not a real market..



Unfortunately for UK investors, the general election has come to its incomplete conclusion at the same time as a roiling European debt and currency crisis. And Greece feels like a Minsky moment not just for Europe, but for the modern democratic - and putatively capitalist - system. We know some of the drill by now. Banks get themselves into trouble through malinvestment and leverage. This is bad enough, but in a fractional reserve and fiat money banking system, banks are deemed to be an essential component of the modern economic framework, too systemically important to be allowed to fail. So they effectively get taxpayers into trouble instead. But this is part of the problem with the democratic process: politicians have a time horizon limited by definition to the next election. If problems can be bundled up and deferred indefinitely to a future generation, they undoubtedly will be. But banks have not just got taxpayers into trouble, the bail-outs they have triggered and the recessions they have provoked have jeopardised the very finances of governments. And while every guest at the feast might want to postpone the bill to the next set of diners, and the next after that, the restaurant ultimately needs to be paid. And the kitchen staff need paying in cash. The system has come to the practical limits of the stress test, and it is being found wanting. When heavily indebted governments no longer have sufficient command of the budget process or the sufficient confidence of the financial markets, who bails ***them*** out ? The

Greek age of austerity has yet to begin, and there is already blood on the streets. Meanwhile the shark-like and ever-hungry financial markets swim on to the next course: Portugal, Italy, Spain..

..But this is

Identifying "safe" assets in such an environment has more than the usual complexity. Even if the search for "safety" is not in itself a quixotic endeavour, it now requires fundamental consideration at both an asset, underlying inherent leverage, and currency level. Government bonds are typically deemed to be "safe" investments – but what are they offering protection against ? In the supposedly developed (now read: heavily indebted) economies, they now offer insufficient protection, we would argue, against credit, inflation and currency risk (these last two are essentially the same). In an environment of anticipated deflation, government bonds are deemed to be "go to" assets. But do we really believe that the heavily indebted governments of the West would permit deflation to set in, within an economic system drowning in debt, without doing everything in their power, both de facto and de jure, to forestall it ?

Notwithstanding the rising tensions and fracturing fault lines within the global financial system, one asset is quietly enjoying a stealth rally. That asset is gold: the one currency that cannot be printed at will, that is independent of political promises for its value. The one true money. Even now, after a rally of some eleven years, this asset remains at the fringes of financial reporting, hoving only sporadically into view, if at all, on the pages of financial newspapers. To say gold is over-owned would be ridiculous. And there is a view that at $1200 per ounce, this asset is now expensive. As the saying has it, if you think education is expensive, try ignorance. Fund managers QB Partners in November 2008 made an attempt to assess the intrinsic value of the US dollar. They did so by assessing the intrinsic value of gold in dollar terms, something they called "The Shadow Gold Price". They assumed that Federal Reserve Bank liabilities were exchangeable into gold and then divided the dollar amount of then current Fed liabilities by official gold holdings. In their words,

"This calculation, while simple, is intellectually honest and produces a[n].. "equilibrium" gold price of [wait for it] approximately $9500 per ounce today ($2.5 trillion divided by US official gold holdings of 8100+ metric tons)."

Depending on the intellectual honesty, professional competence and ethical orientation of your fund manager or adviser, he or she may have an opinion on the "target price" of gold. Suffice to say, in a world beset by fears of:

- Government debt crisis, credit default and rolling credit contagion
- Fiat currency crisis
- Economic stagnation
- Credit deflation
- Monetary inflation

there may be worse ways to find "safety" than in this rather unassuming pretty metal that has by and large held its value for longer than any paper currency in the history of the world. If that leaves us attracting the label "gold bug", well, perhaps there are worse insults to incur at a time when the global financial system appears to be facing a succession of increasingly grave Minsky moments. Banker, for example.

Tim Price
Director of Investment
PFP Wealth Management
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Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com

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