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Something has to give

"More than half of all workers have experienced a spell of unemployment, taken a cut in pay or hours or been forced to go part-time. The typical unemployed worker has been jobless for nearly six months. Collapsing share and house prices have destroyed a fifth of the wealth of the average household. Nearly six in ten Americans have cancelled or cut back on holidays. About a fifth say their mortgages are underwater. One in four of those between 18 and 29 have moved back in with their parents. Fewer than half of all adults expect their children to have a higher standard of living than theirs, and more than a quarter say it will be lower.. for many Americans the great recession has been the sharpest trauma since the second world war, wiping out jobs, wealth and hope itself."

- From a Pew survey on the effects of the American recession, cited in the current issue of 'The Economist'.

"Three years ago, it seemed inconceivable that a country such as Greece would be allowed to default, or exit the euro zone. But back then it seemed equally hard to imagine that Lehman Brothers might fail. Now that Lehman has gone, who knows what the worst-case scenario might be ? Could the euro zone break up ? Could Greece default ? What might happen to other debt-laden nations, such as the US, if the worst case scenario occurred ? The one thing that is clear is that the answers to those questions now depend as much on culture and politics as on macro-economics.. In this new world of sovereign risk, what really matters is a set of issues that cannot be plugged into a spreadsheet. The old compass no longer works."

- Gillian Tett in 'The Financial Times', April 2010.

"Two prisoners have escaped from a prison in Argentina after guards placed a dummy with a football for a head in the watch tower because of a shortage of manpower.. The source said that the video cameras monitoring the perimeter wall had stopped working some months ago. He said that he hoped the incident would alert the authorities to the problems with lack of resources and that politicians would act to improve the conditions."

- 'Prisoners escape after guards put dummy in watch tower', 'The Daily Telegraph', 21 July 2010.

Why did US stocks crash on May 6th this year ? That date saw the biggest one-day points decline – 998.5 – in the history of the Dow Jones Industrial Average. For a brief period, $1 trillion in market value evaporated. Eight large company stocks, including Accenture, fell to a price of one cent, while others, including Apple and Hewlett-Packard, rose to over $100,000 per share. Having fallen by nearly 10%, the market then largely recovered. The precise cause of this extraordinary intra-day volatility remains a mystery. What seems reasonably plausible, though, is that some form of algorithmic trading, whether executed by hedge funds or investment banks (like there's a difference), played a role. The 'essential' function of the stock market is to raise capital for businesses. A secondary but meaningful function is to assist in price discovery, the more or less democratic process of evaluating those businesses, with capital assessed as votes. What is not a core function of the stock market is to act as a playground for high speed leveraged speculators. As Keynes said,

"When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."

Perhaps there is no broader significance to the 'Flash Crash' of May. Or perhaps it signifies an unstable system prior to a deeper breakdown, a fairground ride that, having become unhinged from its core mechanism and having critically departed from its intended function, lurches and accelerates wildly before reaching its own escape velocity. In the same way, a spike in temperatures, a rise or fall in water levels, restlessness in some animals or a surge in human blood pressure are all precursors to an earthquake. The 'Flash Crash' may represent the falcon that cannot hear the falconer.

There may be a fundamental crisis facing the financial markets, but the quality of informed debate in the blogosphere has never been higher. Take, for example, the following paper by Shimshon Bichler and Jonathan Nitzan: 'Systemic Fear, Modern Finance and the Future of Capitalism', cited by Zero Hedge and originating here. The authors contend that the current malaise affecting markets and investor confidence goes beyond the usual, cyclical noise, and represents a more profound existential challenge to the capitalist system itself.

'The Financial Times' has recently been running a series of articles on the topic of stimulus versus austerity. The debate has provoked heat, if not necessarily much by way of illumination, notably with the ongoing spat between historian Niall Fergusson and economist Paul Krugman. That may be because nobody has questioned whether the very terms of the debate are flawed: stimulus versus austerity implies we have a choice. As those countries labouring under the most unsustainable debt loads will discover, the choice is illusory – the aircraft has already reached the point of no return, there is no safe haven, and it is going to crash. Imposing panic austerity measures may indeed accelerate the default process for failing sovereign states inasmuch as it guarantees that vital tax revenues must fall. The patient is ailing but is being bled even faster.

A coinage we continually return to is the insight of Daniel Bernoulli, cited in the late Peter Bernstein's excellent 'Against the Gods: the remarkable story of risk' that for a wealthy investor, the practical utility of any gain in portfolio value inversely relates to the size of the portfolio. Bluntly put, the more you have, the less by way of investment return you really need. There will always be exceptions of course, those congenitally disposed to being risk-takers and the fundamentally *driven*, but in a generalised sense we are convinced that Bernoulli's words are absolutely true. It is but a short step from a focus on seeking moderate returns to a focus on capital preservation. We have long held that for an individual with high net worth – however defined – the primary investment benchmark should be something approximating to cash. Why ? Because alone among the world of investments, cash is the only instrument that can never decline

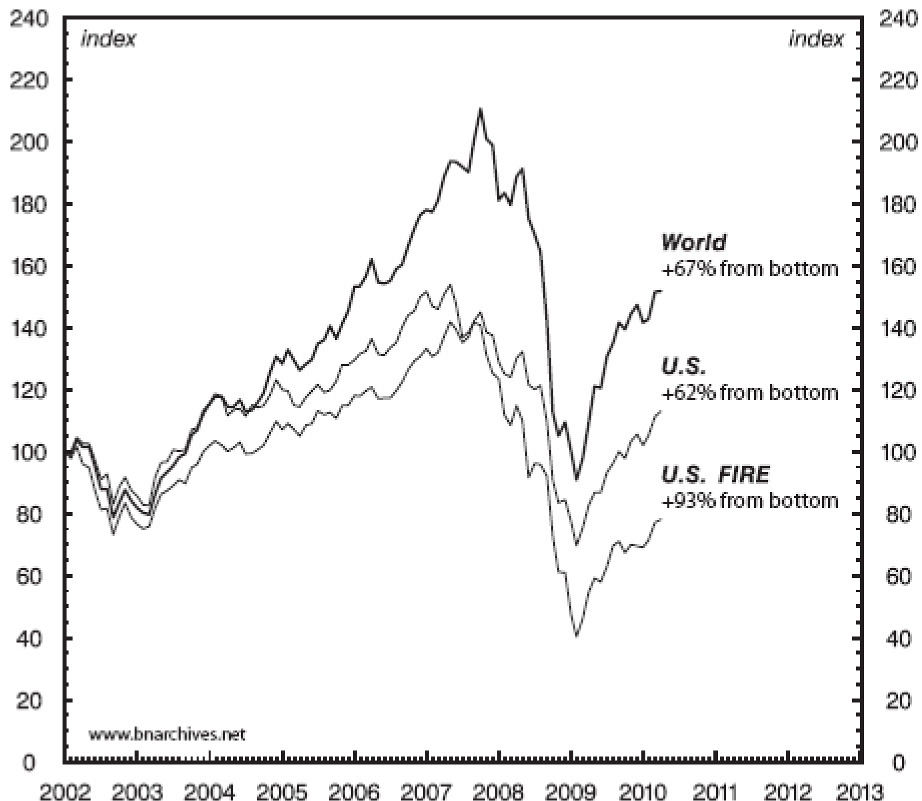
in nominal terms. From these perspectives it is only a short step again to reach the conclusion that for the wealthy investor, the only investment philosophy that makes intuitive sense at all times is to pursue absolute and not market-relative returns.

And these observations bring us to the unique challenge of our times. Can cash really be regarded as the “risk free rate” ? A note of paper currency by and of itself generates no return. It equates to a zero coupon bond until it is deposited within a bank. Under “normal” market conditions this process bears little risk, but in the context of a banking and sovereign debt crisis, we need to recalibrate the very concept of risk itself. Plain money in the bank is now, more so than before September 2008, a risk asset. Even if we continue, erroneously, to view cash as a low or no risk asset, in which currency are we to denominate it ? ‘Buttonwood’ in the current issue of ‘The Economist’ points out the trajectory of the US dollar, for example, in the years since Nixon closed the gold window in 1971. Over the rest of that decade, the dollar lost roughly 90% of its value. During the two decades of the “great moderation”, the dollar recovered, but since 1999 it has been devalued again, relative to the price of gold, to the order of 80%.

Nor can we blithely regard government bills as a proxy for the “risk free rate”. The entire term structure of government debt in the developed world has been distorted by government support for the banks. Overnight rates are near zero, while the rest of the government bond yield curve is kept artificially low by commercial bank purchases (and lately the renewed fear of deflation).

Investors desperately seeking a return on their capital – since cash assets are currently generating negative real returns – have understandably flocked back into the stock market:

World stock markets,including US FIRE (the financial, insurance, real estate sector)



(Source: Bichler and Nitzan)

In the words of Bichler and Nitzan,

"Suddenly, the bulls are everywhere. The greatest returns are usually earned during the initial part of a rally, and no respectable fund manager likes being beaten by a rising average. With the economy apparently bottoming out and with the stock market having been in a major bear phase for nearly a decade, investors are no longer afraid of losing money; their fear now is not making enough of it. And so arises the spectre of "panic buying," a frenzied attempt to jump on the bandwagon before the really large gains are gone.

"Of course, not everyone buys this rosy scenario. Many observers continue to feel that the recent stock market rally is no more than a dead-cat bounce. In the eyes of the pessimists, investors are knee-jerking to a false start. The economic recovery, they say, will be W-shaped, and the market will re-collapse before any real boom can begin. This recession, they warn, is nasty, and likely to linger for years."

Whatever the prospects for the stock market, investors and those participating in the austerity / stimulus debate are overlooking a crucial fault line in the set-up of the modern financial world. The markets are so badly dislocated because their oversight and direction has been entrusted to the same entities that are responsible for the banking system and for the uncontrolled expansion of credit that is the proximate cause for the present financial and sovereign debt crisis, namely the central banks. Einstein defined insanity as doing the same thing over and over again and expecting different results. He might have said the same for expecting the thief that has mugged you to protect everyone else's assets, or for hoping in some inchoate way that a crisis precipitated by the monstrous growth of debt can somehow be resolved by the further expansion of that same debt, masquerading as "stimulus". Realists may wish to ponder just how successful, and not least expensive, has been the stimulus experienced within the US economy: $1.75 trillion of quantitative easing and a fiscal deficit above 10% of US GDP have achieved the economic, employment and wealth outcomes cited in the Pew survey above.

So perversely, while generating a "cash-plus" return seems like an easy objective with cash rates so close to zero as makes no difference, it in fact carries abnormally high risks, because we inhabit an abnormally high risk environment. Europe's ludicrous stress tests notwithstanding, banks are not riskless, cash is not riskless, ostensibly high quality debt is not riskless – we would cite both credit and inflation risk as meaningful long term threats – and equity markets are dancing to a tune that we for one cannot hear. Gillian Tett is surely right. Economics alone is no guide, because the current 'long emergency' requires a nuanced appreciation of wider cultural and political affairs. Bichler and Nitzan also suggest that investors are making fundamentally bad judgments by taking their cue from current statistics – what has gone before, what used to work – rather than being rationally predictive, and trying to assess what lies ahead, at a time when the market environment is radically different from any other in living memory. Cash; currency; credit risk; bank risk; deflation now; inflation later; what happens to wealth and society as a whole when levels of personal and sovereign indebtedness, internationally, have reached the point of no return. Buttonwood in 'The Economist' this week concludes its assessment of bonds, deficits and currencies with four stark words. ***Something has to give.***

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