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Tales of the expected

"A theorem: *In matters of military contingency, the expected, precisely because it is expected, is not to be expected.* Rationale: What we expect, we plan and provide for; what we plan and provide for, we thereby deter; what we deter does not happen. What does happen is what we did not deter, because we did not plan and provide for it, because we did not expect it."

- Sir Michael Quinlan, cited in 'The Secret State: preparing for the worst; 1945-2010' by Peter Hennessy. Hat-tip to S.G.

Another theorem: two years after the failure of Lehman Brothers, literally anything is possible. In financial markets, the boundaries of possibility had previously been circumscribed by a limited number of core beliefs or assumptions: that debt rated 'investment grade' was sound; that credit ratings agencies were broadly competent and, as state-sanctioned quasi-monopolies, acted objectively on behalf of the public good; that developed world government debt was essentially riskless; that investment businesses that became insolvent could be wound down in an orderly manner; that regulation of the financial sector existed; that banks operated on a broadly level playing field with the rest of the economy; that financial markets were largely benign structures that operated efficiently; that bankers were motivated by considerations other than greed and self-preservation. In shorter form, that free market capitalism **worked**.

Some, if not all, of those assumptions have not survived their first serious contact with the enemy. We are increasingly accused of labouring what we perceive as the unusual if not unique 'riskiness' of the current situation, as if we weren't already aware that sounding a continual note of extreme caution is not exactly conducive to encouraging new investment business. At the risk of appearing either trite or inadvertently offensive:

First the sub-prime assets sold off,

And I wasn't much bothered because I didn't own sub-prime assets.

Then the bank stocks sold off,

And I wasn't much bothered because I didn't own bank stocks.

Then the equity markets sold off,

And I wasn't much bothered because I have a diversified portfolio.

Then Big Government stepped in and bailed out everybody,

And I got a little bothered because I believe in free markets and not the socialisation of banking losses.

Then government finances became imperilled,

And I got a little more bothered because there are only so many safe havens.

Then neo-Keynesian economists were allowed to dominate the debate,

And they shouted louder than everybody else for the creation of yet more debt.

Then quantitative easing threatened to go 24/7,

And I got a little more bothered because there are no good historical examples of unrestrained money-printing or currency debauchery that ended well.

Then the wheels well and truly fell off,

And by that time there was nowhere left to go.

Recent history, as in within the lifetime of anyone engaging with this commentary, is not necessarily up to the task of assessing the risks facing the modern investor, anywhere except Japan over the last two decades, the example of which does not exactly lend itself to any market view that could be described as bullish. If you disagree with this statement, you will need to identify a period in peacetime during the last century when government indebtedness globally has been higher, when the level of embedded entitlements throughout the economy has been higher, when unfunded state liabilities have been higher, and when confidence in fiat currencies – if only as inversely evinced by the nominal price of gold – has been lower.

More distant history, however, **is** up to the task. Zero Hedge carries a link to Eric King's latest interview, with Jim Rickards, former LTCM General Counsel, who is obviously familiar with what a gigantic financial ~~clusterf~~ crash looks like, from the inside looking out. Comparing the last days of the Roman Empire with the US in its current form is obviously unfair: when Rome collapsed, it was not indebted to the gills. In some other regards the comparison bears consideration. Rome's silver denarius started out pure and over a period of debasement ended up with barely 5% silver content. Its population was assailed by ever-increasing taxation, to the point where farmers didn't just leave their fields fallow but simply abandoned them altogether. As Zero Hedge also points out, unlike the Romans, the inhabitants of the US

"are way beyond the point of diminishing marginal utility, and the amount of money that must be printed, borrowed, taxed and spent for marginal improvements in the way of life, from a sociological standpoint, is exponentially greater than those during Roman times."

History is also replete with premature storm warnings. Cicero declaimed as follows:

"The national budget must be balanced. The public debt must be reduced; the arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced, if the nation doesn't want to go bankrupt. People must again learn to work, instead of living on public assistance."

All worthy sentiments acutely relevant to the concerns of today. But they were spoken in 55 BC. If defined by the deposing of Emperor Romulus Augustus by the Germanic chieftain Odoacer, the Roman Empire didn't actually fall until 476 AD, some five centuries later. But then ancient Rome never had CDOs, the Federal Reserve, or Goldman Sachs.

The extreme polarities of the current clash between optimists (and you'd likely be optimistic if you'd been granted $700 billion to save your bank from otherwise certain death, much of which you then chose to appropriate as bonus payments) and pessimists (*definition*: realists not working on Wall Street) is manifest in the schizophrenic behaviour of many putative financial professionals, not to say uninvolved members of the public. On June 30th, Barton Biggs, a c. 200-year-old hedge fund manager and former Morgan Stanley banker, told Bloomberg News that bullish market bets accounted for roughly 70% of his portfolio ("I still believe that it's just a soft spot"). By July 2nd, Mr Biggs (arf !) had cut his bullish bets by about half ("I'm not wildly bearish, but I don't want to have a lot of risk"). By July 26th, Barton Biggs had reverted back to optimism ("I clearly think that the right thing to do is to be bullish"). Maybe not that clear. We would suggest that the right thing to do is not to chat to Bloomberg News every time you exhale. For more from the Barton Biggs school of conviction investing..

Devin Leonard of Bloomberg also reports the comparably schizophrenic attitude of US consumers who "splurge on high-end discretionary items and cut back on brand-name toothpaste and shampoo". There may be 15 million Americans out of work; let them buy iPads.

Quinlan's theorem, of course, is also somewhat deficient. It assumes in a military context that the business of planning of itself constitutes a process of successful deterrence. If that were true when it was written, it is less likely to be true now, given the rise of asymmetric warfare and a military establishment of diminished resources now dealing, as our American friends at some point will, with the implications of the end of empire. But it utterly fails to address the problem with investment. Planning and provision may only have modest correlation with deterrence. Even if we correctly anticipate a problem (say, by responding to the ongoing rape of fiat currency with the purchase of gold), there is no guarantee that extraneous factors, not least politicians, will not arbitrarily change the rules of the game. But for as long as we want to stay in the game, we surely have an obligation to try and play it to the best of our abilities, come what may.

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