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The Trillion Pound Drop

"The Federal Reserve System is the central bank of the United States. It was founded by Congress in 1913 to provide the nation with a safer, more flexible and more stable monetary and financial system. Over the years, its role in banking and the economy has expanded."

- Overview of the US Federal Reserve System; their words, not mine.

In Channel 4's 'The Million Pound Drop', a motley collection of not necessarily super-intelligent contestants are given a million pounds and then have to navigate through eight questions to keep as much of it as possible. This obviously bears little resemblance to the financial sector bailout that began in 2008, where a motley collection of not necessarily super-intelligent bankers are given, directly or indirectly, trillions of pounds, no questions asked, and get to keep all of it. In the UK, cinephiles who have not yet exhausted their penchant for financial miserabilism eagerly await the release of Charles Ferguson's documentary 'Inside Job', which he summarises as follows: finance is simply too important to be left to the financiers.

The latest iteration of the Trillion Pound Drop is in the form of the next anticipated wave of quantitative easing, or QE2. There is no evidence whatsoever that quantitative easing works – the evidence from the Japanese, who were the first to deploy it, is inconclusive at best – but it is a sign of the desperation of central bank administrations pushing on strings that they will now do whatever they can to pre-empt deflation, even if it amounts to incinerating the wealth of nations and provoking an international currency war in the process. Conventional monetary and fiscal policy has either run into the sand or has exhausted all other options. In the words of John Hathaway of Tocqueville Asset Management, as reported on Bloomberg,

"Monetary policy has painted itself into a corner."

The US Federal Reserve is no longer fit for purpose, assuming it ever was. (The 1995 documentary The Money Masters posits that "the Fed" is not a governmental institution as its name implies but an unaudited assembly of private banking interests with some limited government input.) It has a dual mandate – to control inflation and promote full employment – but has torched the first objective and conspicuously failed on the second. Austrian and monetary economists would observe that inflation is not a generalised rise in prices but the increase in the money supply that tends to precede it. By this definition, we are already in inflationary territory, or at the very least the seeds are being sown. Ranged against this inflationary central banking maladministration are the deflationary forces of ongoing global deleveraging, which we acknowledge in our recent webcast. The near term outcome is uncertain but the longer term implications are unlikely to be benign.

In his excellent and thoroughly watchable presentation 'Arithmetic, Population and Energy', Dr Albert Bartlett, physicist at the University of Colorado at Boulder advocates the thesis that as human beings our greatest shortcoming is our inability to understand the exponential function. This may sound intimidating but is not meant to be. An exponential function is simply one in which a variable increases at a fixed rate or percentage per time period (1,2,4,8,16..), as opposed to an arithmetic function (1,2,3,4..) in which growth is by a fixed amount each period.

The global population is growing exponentially. At some point in the comparatively near future, the world will experience zero population growth. This is not debatable, it is certain, because the finite carrying capacity of the earth will determine it. The politicians of today and tomorrow will have some say in how it comes about – whether through starvation or voluntary population controls, say – but it is certain to happen. But population is not the theme of this commentary. Returning to the theme of exponential growth, the world economy, underpinned by fiat currency, the provision of bank credit and fractional reserve banking, requires constant exponential growth – if only to maintain the interest payments on its systemic debt. Without exponential growth, the system will collapse. We are trapped on a treadmill that demands ongoing expansion. So it is now an open question whether we have reached the end point of conventional finance and economic growth – credit, courtesy of banking sector mania and inept regulatory oversight, has finally overreached itself. The cost of credit, in the form of interest rates, has in response been manipulated by the central banking authorities as low as it can go, and it is ***still*** not enough to trigger a reflationary pick-up in economic activity. The Bartlett presentation is an extraordinary effort, but its implications are more extraordinary still: for population, for energy and now – we suspect – for our banking and economic outlook. Notwithstanding the machinations of the bureaucrats and politicians behind the regulatory curtain, as Star Trek's Scotty was wont to observe, ye cannae change the laws of physics.

Our webcast indicates how we are endeavouring to navigate these rapids – essentially, in a four-fold diversified approach. To generate income and preserve capital in a deflationary context, the highest quality sovereign bonds. To participate in what growth may come from the real economy, diversified but primarily defensive high quality equities. To preserve capital again, well managed and largely index-unconstrained absolute return funds. And to preserve capital in currency terms and to hedge against inflation (possibly deflation) and further financial chaos, gold and silver bullion and related investments.

In the words of Tocqueville's John Hathaway,

"The only questions are how long the denouement of the dollar reserve system will last, and how much more damage will be inflicted by new rounds of quantitative easing or more radical monetary measures to prop up the system."

We don't claim to have all the answers, or for all time, but we do believe that a prudently diversified portfolio of high quality assets constructed along the lines above is better than simply and conventionally hoping for the best, even as the storm picks up in volume and intensity.

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