PFP
Wealth Management

3 Windsor Court
Clarence Drive
Harrogate, HG1 2PE
01423 523311

Lion House
72-75 Red Lion Street
London, WC1R 4NA
020 7400 1860

www.pfpg.co.uk

9th January 2012

A revolutionary road

"Some investors aren't confident with what gold is backed by, as compared to something like the US dollar. Investors are comfortable that the US dollar is backed by the US government."

- CTV national news field reporter Bridget Brown. This channel should perhaps be called WTF ?

Sam Mendes' 2008 film 'Revolutionary Road' is edited to maximise heartbreak among viewers. Its opening scene shows bright young things Frank (Leonardo DiCaprio) and April (Kate Winslet) falling for each other at a New York party. Without missing a beat it then cuts to April displaying a mediocre performance in a mediocre amateur drama, which Frank is only too willing to point out. By this stage they are already married, with children and a brooding mutual resentment. Whatever happened, we are urged by this brutal jump cut to ask, to love's young dream ? The disenchantment foisted upon us by the slow death of honest, free market capitalism, and of any form of political integrity, has, by contrast, taken its time coming. But that disintegration and its accompanying, lingering sense of existential despair are just as sure. There has been profound change in the markets over the last decade alone, and none of it good.

Crisis historians can take their pick deciding precisely when the rot set in. Our suggestion would be President Nixon's 1971 abandonment of the dollar to an unbacked, purely fiat status. That, in turn, allowed all other currencies to start out on the road to hell together. Other candidates include the 'Greenspan put' variously displayed ***after*** the 1987 Crash, ***during*** the 1998 bail-out of Long Term Capital Management, ***before*** the year 2000's "Millennium Bug" (sic), and ***after*** the dotcom bust (***ahead of***, and igniting, the US property boom that proved both *pièce de résistance* and *coup de grâce*). But whatever the proximate cause of the death of free market capitalism, by the time that Lehman Brothers failed (six months ***after*** the emergency bail-out of Bear Stearns) the patient had already entered a climactic decline, and now suffers fitfully under life support.

There are two specific characteristics of the sort of behaviour that has fuelled the flames of the crisis to new intensity. One is a wilful refusal on the part of individuals to take responsibility for their actions that annihilates the concept of professionalism. On occasion this looks uneasily similar to naked self-interest. A good current example is Philipp Hildebrand, chairman of the Swiss National Bank, who has brought grave indignity upon the office and credibility of the Swiss National Bank by allowing his wife to punt the foreign exchange market. Whether he, or his wife, is guilty of insider dealing is beside the point. The point is that Caesar's wife must be above suspicion. The other crisis behaviour, even more damaging, is that fostered by the childish technocratic delusion, taken to giddying heights under Alan Greenspan but perpetuated by his successor, that no matter how disgusting its transgressions, the banking sector should always and under all circumstances be spared the pain of a reconciliation with reality. In this way the sins of

the bankers are being visited upon the rest of the global economy. Bill Gross, manager of the $240 billion Pimco Total Return Fund, is probably the most influential bond manager in the world. In his latest note 'Towards the Paranormal' he points out that in their absurd, desperate, Basil Fawlty-ish attempts to prop up the unpropuppable, central banks, but primarily the Fed, have so distorted the term structure of interest rates that a) the financial markets no longer operate rationally, and more ominously still, b) banks themselves, with monetary policy rates at zero, now have little option but to delever:

".. "zero-bound" interest rates may be eating away like invisible termites at our 40-year global credit expansion.. Zero-bound money – credit quality aside – creates no incentive to expand it. Will Rogers once fondly said in the Depression that he was more concerned about the return of his money than the return on his money. But from a system-wide perspective, when the return on money becomes close to zero in nominal terms and substantially negative in real terms, then normal functionality may break down. We all start to resemble Will Rogers.

"A good example would be the reversal of the money market fund business model where operating expenses make it perpetually unprofitable at current yields. As money market assets then decline, system-wide leverage is reduced even if clients transfer assets to banks, which themselves reinvest proceeds in Fed reserves as opposed to private market commercial paper. Additionally, at the zero bound, banks no longer aggressively pursue deposits because of the difficulty in profiting from their deployment. It is one thing to pursue deposits that can be reinvested risk-free at a term premium spread – two / three / even five-year Treasuries being good examples. But when those front end Treasuries yield only 20 to 90 basis points, a bank's expensive infrastructure reduces profit potential. It is no coincidence that tens of thousands of layoffs are occurring in the banking industry, and that branch expansion is reversing industry-wide..

"That front ends of yield curves are relatively flat at near zero percent interest rates is critical as well. If they were flat at 5% as in 2007, then banks and investors could extend maturities with the possibility of capital gains. Now at 1% or lower, they cannot. Leverage is constrained. **Conceptually, when the financial system can no longer find outlets for the credit it creates, then it de-levers."** [Emphasis ours.]

Capital punishment – nominal and real yields available in the US Treasury market

Instrument	Nominal yield	Real yield
1 month bill 2.2.2012	0.00%	-3.4%
3 month bill 5.4.2012	0.01%	-3.39%
6 month bill 5.7.2012	0.05%	-3.35%
1 year bill 13.12.2012	0.10%	-3.3%
2 year note 1/8% 12.2013	0.26%	-3.14%
3 year note ¼% 12.2014	0.39%	-3.01%
5 year note 7/8% 12.2016	0.88%	-2.52%

Source: Bloomberg LLP. Real yield assumes CPI y-o-y at 3.4% (data as at 30.11.2011)

Deleveraging by corporates and households is one thing – in last week's commentary we highlighted the recent work of Richard Koo in the context of a global balance sheet deleveraging recession / depression. But when the banking sector is doing it as well, look out below for asset prices. And as we suggested, already grossly indebted western governments are not in the same position as Japan during its lost decade – they are no longer in the bond market's good graces and the possibility of increasing their already eye-watering debt loads is vanishingly small. What is probable, however, is that at some point in 2012 and possibly quite soon, we will see a heavily indebted western sovereign, and perhaps a large one, go bang, taking its banks and bondholders down in the process. The banks have made a pretty good fist thus far of doing their best to destroy the economy. It now looks as if governments and central banks, in a futile attempt to save the banks, will finish the job. Quite who wins in the global gut-barging contest between private sector deleveragers and public sector inflationists is unclear. But for as long as the battle continues, it makes sense to sit it out on the sidelines, at least as far as leveraged assets are concerned. Crudely, if one is forced to make a choice, unencumbered real assets look compellingly more attractive than heavily levered financial ones.

The willing suspension of disbelief permits directors to cram a lifetime and its attendant emotional baggage into just 90-odd minutes of screen time. 'Revolutionary Road' ultimately doesn't quite engage because that original, sparky chemistry between the two leads comes across as a little false; DiCaprio is overly winsome and fey, and Winslet is a bit too much of a heffalump. But it is the perfect film for this economic and financial environment, because in the final analysis the gloom seems unavoidable, and there seems no realistic chance of escape or hope of redemption; it is a quite profoundly depressing experience. *[Note to investors: this is what they mean when they say 'managing expectations'.]*

Tim Price
Director of Investment
PFP Wealth Management
9th January 2012.

Email: tim.price@pfpg.co.uk   Twitter: timfprice

Weblog: http://thepriceofeverything.typepad.com   Group homepage: http://www.pfpg.co.uk

Bloomberg homepage: PFPG <GO>

Important Note:

PFP has made this document available for your general information. You are encouraged to seek advice before acting on the information, either from your usual adviser or ourselves. We have taken all reasonable steps to ensure the content is correct at the time of publication, but may have condensed the source material. Any views expressed or interpretations given are those of the author. Please note that PFP is not responsible for the contents or reliability of any websites or blogs and linking to them should not be considered as an endorsement of any kind. We have no control over the availability of linked pages. © PFP Group - no part of this document may be reproduced without the express permission of PFP. PFP Wealth Management is authorised and regulated by the Financial Services Authority, registered number 473710. Ref 1002/12/JD 090112.