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Wheelbarrows

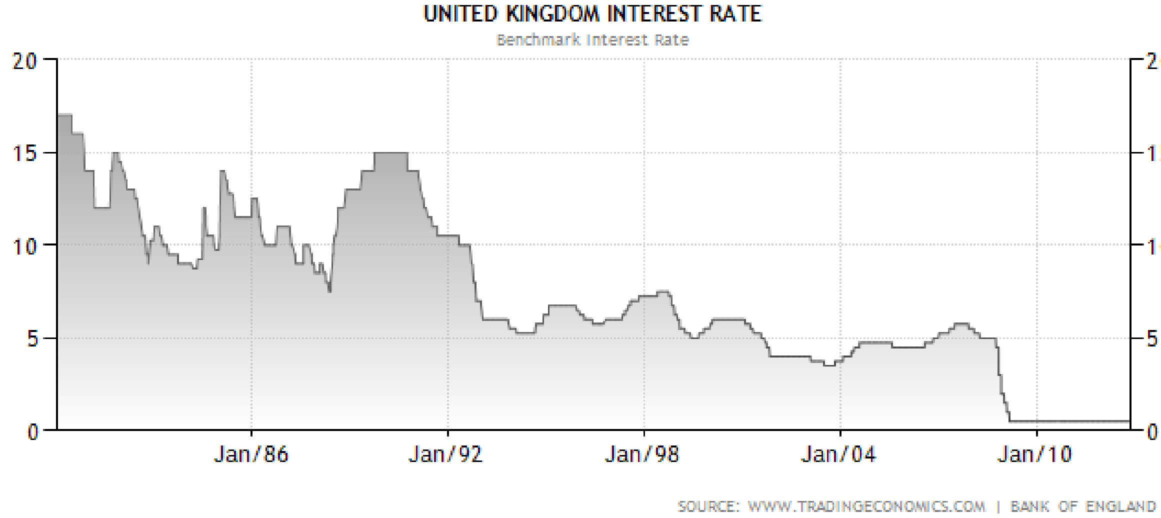
"Sir, What could be more appropriate than rebranding euro bank notes with Europa* to improve security ? The euro's strength is a myth and its bosses' attempted seduction is all bull."

- Clark McGinn, Dublin 4, Ireland, in a letter to the Financial Times, 10.11.2012.

*Europa, in Greek mythology, after whom the continent of Europe was ultimately named, was abducted by Zeus in the form of a white bull. Apparently.

'Black Guy Asks Nation For Change' was how The Onion memorably reported Barack Obama's first presidential victory. Now that Mr. Obama has won a second term, that reference to 'Change' looks a little hollow. In matters fiscal or economic, no matter how hard you look, you will see little real evidence of change on either side of the Atlantic. What you will see is plenty of policy drift, accompanied by a one-tone medley of cans being continually kicked further into the future.

Two particularly concerning things were reported in The Financial Times last week. Both of them related to the UK government's parlous mountain of debt. Before we get to the first, consider the chart below, which shows UK benchmark interest rates over the past thirty years. Having reached the high teens in the early 1980s, the UK base rate now sits at 0.5% - an all-time low.



A chart of Gilt yields would have a similar shape. The chart below, for example, shows 10 year conventional Gilt yields since 1992.

10 year UK Gilt yields, 1992 - 2012

Whereas 10 year Gilts offered a 10% yield back in 1992, now they yield less than 2% - and the government has more need to issue them than ever before. What kind of idiot would be buying them here ? Answer: pension funds. As the FT reported last Thursday,

"UK pension funds are holding more bonds than equities for the first time since the so-called cult of equity in the 1950s.."

To be fair to the pension funds, their own stupidity at crowding into bonds at their most expensive levels in history is only half of the story; a desperately indebted government is also doing its bit, by forcing them through the medium of "financial repression" to hold Gilts at the expense of anything more sensible. You may recall, for example, the Dutch pension fund last year that elected to try and protect the purchasing power of scheme members' capital by buying gold. The Dutch regulator tried to force them to sell their gold on the basis that it was "risky" – a definition of risk that evidently only heavily indebted governments would use. The Dutch regulator lost the case on appeal.

In relation to the UK situation, Alasdair MacDonald of pensions consultants Towers Watson commented:

"This is a watershed moment for UK pensions."

A watershed moment, perhaps – as in something so horrible that it should only be seen by consenting adults. "Waterloo" seems a little more appropriate – and Gilts are playing the role of Napoleon.

The second frightening thing that surfaced in the pages of the FT last week was the story, reported by Chris Giles and George Parker, that

“[UK Chancellor] George Osborne has decided to grab about £35 billion of surpluses being built up under the Bank of England’s money-printing operations, making it easier for the chancellor to meet his rules on public finances.”

“We are being totally transparent about this,” said one aide.

Transparent as in: easily seen through. Jeremy Warner for The Daily Telegraph responded to the Osborne grab in a piece titled

‘The Bank of England has just crossed the line into straight government financing’.

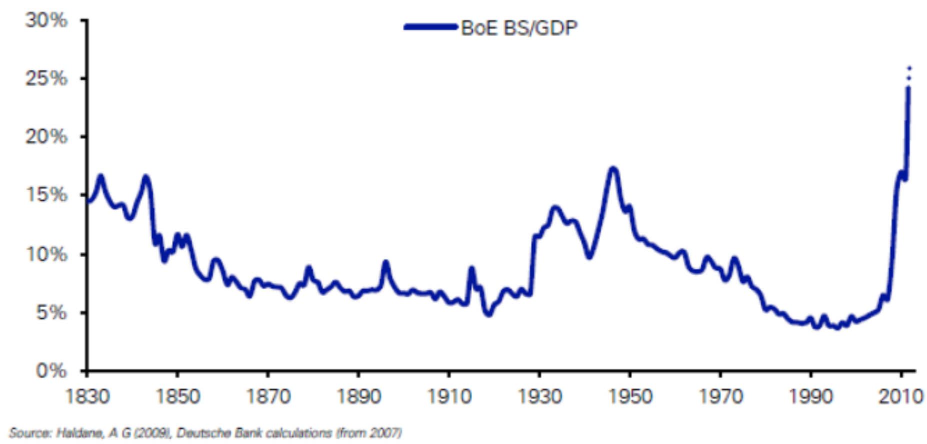
In it, he writes:

“The Government excuses its actions by saying that it is only bringing itself into line with practice in Japan and the US, the other major economies to be practicing substantial QE right now. It might also be argued that to the extent the European Central Bank indulges in bond purchases, it practices something quite similar too.

“In any case, you might reasonably think that it doesn't really matter how the government accounts for the interest on the Bank's stock of gilts. Since the Bank of England is 100pc owned by the Treasury, the government has in essence only been paying interest to itself, so why not just stop the charade and save the money?

“Wrong, wrong, wrong. The justification for keeping the interest is that it creates a buffer to fund expected losses on the gilts when the Bank of England comes to unwind its quantitative easing programme. These losses are now going to have to be met by the government directly at some stage in the future. Alternatively, the government could simply ignore them or write-them off. The Government is transferring the losses from today until tomorrow. The thin line which separates monetary from fiscal policy is being crossed in a way which substantially undermines the Bank of England's claim to independence.

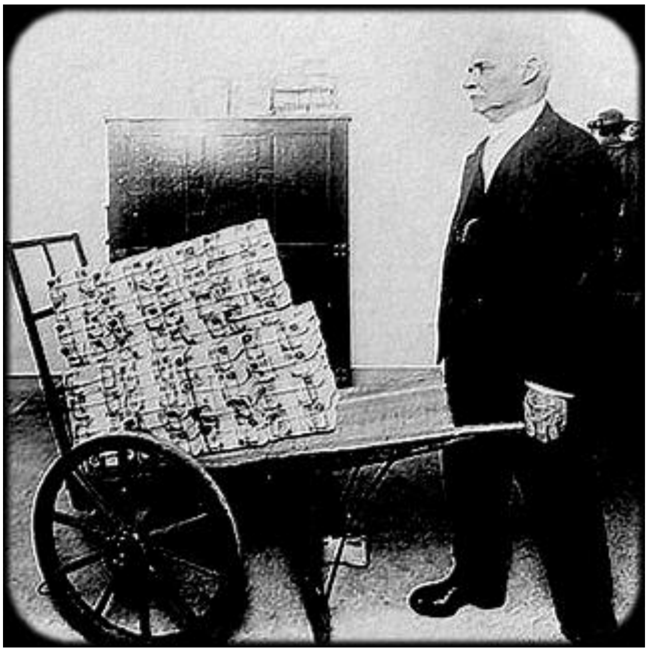
“Using the precedent set by the Bank of Japan by way of justification is instructive, because no-one any longer believes the Bank of Japan is independent of government. It is the mere puppet of deficit spending politicians.”



The chart above, courtesy of Deutsche Bank, shows the Bank of England’s balance sheet relative to UK GDP. Stuffed with Gilts, it has never been higher. And as Newscape Capital point out, the

Bank of England now owns £375 billion of Gilts purchased under the Asset Purchase Facility. That equates to more than one third of outstanding Gilt issuance. (Presumably the pension funds own the rest.) So the question now is: is an orderly exit for the Bank of England and its mountain of Gilts now even possible, given the size of the liabilities involved ? This is what happens when governments practise Zimbabwe economics. Among the first reader responses to Jeremy Warner's piece on the Telegraph website: "buy wheelbarrows".

"We are being totally transparent about this"



Courtesy Google Images.

Marc Ostwald of Monument Securities said it showed "just how desperate Osborne was" to find funds, and that

"It blurs the divide between fiscal and monetary policy even more, and some may well say that this is tantamount to monetising the deficit."

For investors, the correct response is surely to steer even closer to shore. If one must hold bonds, they should be of unimpeachable credit quality. But taking a leaf out of the pension funds' book – and doing precisely the opposite – probably also makes sense. If pension funds are stampeding out of the stock market, they may have left some bargains behind. We have never held with index tracking, but sensibly priced, defensive stocks with decent yields and good dividend cover ***never*** go out of fashion. And we would complement high quality debt and equity holdings with uncorrelated assets (either genuine 'absolute return' funds or holdings in systematic trend-following funds) and, now more than ever before, real assets, including our perennial favourites, the monetary metals, gold and silver.

And either buying, or making, wheelbarrows probably makes sense as well.

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12th November 2012.

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