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That deflating feeling

"I would rather lose half of my shareholders than half of my shareholders' money."

- Jean-Marie Eveillard, quoted by Sebastian Lyon in Personal Assets Trust's 2013 annual report.

Financial analyst and markets historian Russell Napier has an excellent feature in the current MoneyWeek magazine, in which he warns of outright deflation. He also touches on the surreal farce that passes for today's grossly distorted financial markets. "For all its problems and excesses," he writes, "the credit-boom era was still better than the current nightmare of having asset prices effectively set by governments." And he quotes from the 1810 Bullion Committee established by the British government to assess whether an independent central banker should be responsible for managing monetary policy:

"The most detailed knowledge of the actual trade of a country, combined with the profound Science in all the principles of Money and circulation, would not enable any man or set of men to adjust, and keep always adjusted, the right proportion of circulating medium in a country to the wants of trade."

As Napier puts it, this sums up why we should always be prepared for central bank failure in the conduct of monetary policy. It is entirely beyond the practical ability of any one man or group of individuals. It is certainly beyond Ben Bernanke or "Sir" Mervyn King. This is a blind spot in economics shared by almost everyone, including self-appointed economic "experts" like Messrs Wolf and Krugman. We allow free markets to operate and set prices in just about everything except where it matters most: in the price of money, where, mysteriously, only central bankers have the apparent wisdom to do the job. In Napier's words, the entire history of central banking is the history of failure.

Investors globally have been wrestling with one overarching question since the financial crisis erupted in 2007: inflation, or deflation ? Or to reduce it more crudely to the level of asset classes: equities, or bonds ? For the last five years, both equity markets ***and*** bond markets have done pretty well, thanks to a combination of aggressive monetary stimulus and financial repression. But the good times cannot last; as Napier puts it, inflation is the ***only*** solution to the global debt crisis:

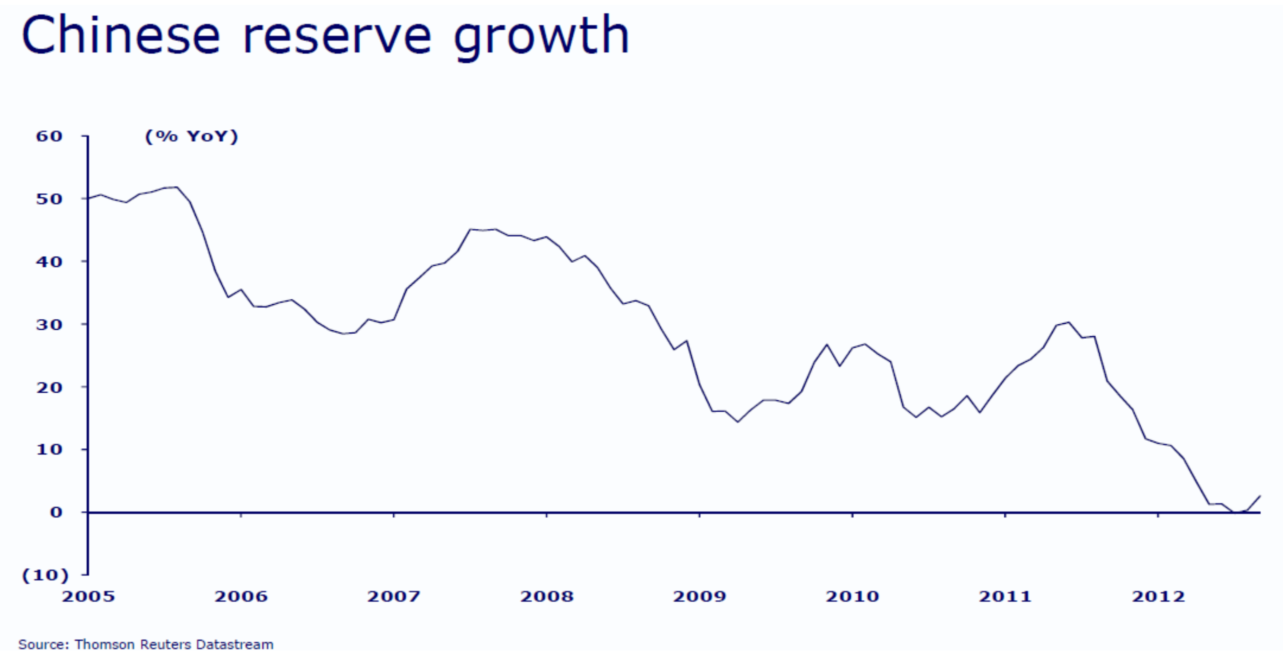
"This we know for sure: in the long run, governments must inflate away their debts. This is politically the easiest answer to a difficult economic problem."

We share this view about how an unpayable mountain of debt gets solved – by explicit state-sanctioned inflationism; this is why we hold gold. Meanwhile,

"the external surpluses that forced emerging markets to adopt easy money policies (to try to cap the strength of their currencies) and also resulted in high growth, have been waning for almost two years. Now surpluses have been eradicated, and attempts to keep exchange rates steady will result in tighter monetary policy (now needed to prop up currencies that are tumbling against the dollar) and a resulting hit to the demand outlook.. This dynamic in emerging markets suggests that the next central bank failure is likely to result in deflation. If that's the case, then investors should be in cash or in the government bonds of countries that really don't have very many government bonds (in other words, they're not particularly indebted)."

We already hold these sort of bonds, as they form the core of the Wealthy Nations Bond Fund (discussed here ***passim***). Like us, Napier also likes prospects for the Singapore dollar as opposed to sterling.

In his presentation at this year's MoneyWeek 'Fight or Flight' investment conference, Napier highlighted the "evaporation" of emerging market external surpluses. You can see the data for Chinese foreign exchange reserve growth below; the trend for reserves across Indonesia, Russia, Taiwan, India, South Korea, Brazil, Thailand and Hong Kong tells the same story.



So we may finally have an answer to that huge macro-economic question: deflation first, and ***then*** inflation. The weakness in the price of gold may well be signalling the former; but if we end up with the latter, it will make absolute sense to retain exposure to the physical asset. Shorter term price weakness notwithstanding, it also makes sense, we think, to retain exposure to gold as protection against systemic financial distress. We could, of course, sell our gold – but then what would we do with the proceeds ? Napier may like bank deposits, but we don't.

Pimco's Bill Gross suggested last week that Federal Reserve chairman Ben Bernanke was "deathly afraid" of deflation. Gross is probably right. But just because a Fed chairman is afraid of something doesn't mean he can automatically prevent it from happening. Confused financial markets spent much of last week churning and writhing in desperate uncertainty as they struggled to interpret

Bernanke's latest pronouncements on (conditional) "tapering" of the Fed's QE programme. It may well be that if risk assets fall further and precipitously, or if the US economy underperforms the Fed's forecasts, then we will be in for plenty more QE – Bernanke has reduced Fed policy to a permanent pushing on strings. But making one's investment policy a hostage to the subjective interpretation of what some idiot central banker says, or means, or might mean, or might do, is nonsense. Better by far to diversify widely, and only to invest into objectively high quality assets on the basis of objectively attractive valuations.

The UK's Parliamentary Committee on Banking Standards last week proposed to jail reckless bankers. Playing to the gallery and cynically courting public opinion is bad enough. But it is scandalous that our lawmakers pay little or no attention to the even more damaging recklessness of the world's *central* bankers as they play games with the financial markets that none of us can really afford to lose.

To listen to last week's PFP investor conference call, simply click here.

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