PFP
Wealth Management

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

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

www.pfpg.co.uk

3rd August 2009

Bonderdämmerung

"You don't take a very responsible job at a time like this and jump after eight months to make money in the private sector."

- Anonymous 'Senior City banker' quoted in The Financial Times after John Kingman of UK Financial Investments said he was stepping down. This response would seem to indicate that a) banking itself is irresponsible; b) the anonymous banker explicitly acknowledges he himself is in it for the money; c) bankers still dominate the field in the hypocritical delivery of advice to others; d) the coinage 'banker' has now completely replaced its assonant rival as a term of abuse to describe the hopelessly objectionable and contemptible.

The great Austrian economist Ludwig von Mises had the final word about a terminal credit crunch:

"There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved." (Mises, 'Human Action', 1949.)

But there is an almost insurmountable problem in viewing the investment markets through the rigid and unforgiving prism of the so-called Austrian school. Mises wrote of the world as it should be. We live in the world as it is. Our own investment markets, or at least those of the supposedly developed west, are now government-directed parodies of free markets – having theoretically been at economic war with socialism and communism, and having seemingly triumphed as the Berlin Wall fell, the governments of the west have now adopted much of the socialist-driven command economy model that they had ostensibly vanquished as recently as 1989.

CLSA's Russell Napier has written well of these challenges in otherwise implementing an Austrian resolution to the banking and credit crisis. The challenges are both political and cultural, and as such, trying to finesse timing issues whilst navigating the murky swamp of moral hazard that currently buoys up the banks is probably close to impossible. In his June research note, 'How the rally ends', he points out that the

"long-awaited "Austrian moment" produced nationalisation rather than creative destruction. The next cycle will now be dominated by a government owned / directed credit cycle triggered and sustained by fiscal profligacy. The ultimate result of this will be that the true creative destruction will come, eventually, through the government debt markets. Given the government's willingness to jump into the credit breach, the great US credit supercycle can only end with the collapse in

the credit quality of the US government itself. Then, and only then, can we witness the much awaited creative destruction."

In a bid to ensure its own survival, the US government has reacted to this otherwise Austrian moment of truth

"by turning water into apparent wine and turned US commercial credit risk into sovereign credit risk. Starting with Freddie and Fannie and spreading to the entire banking system and even the automobile sector, huge swathes of commercial credit have been given sovereign credit status. That support is being passed on through nationalised financial institutions to the residential property market and beyond. Creative destruction in the form of depression and deflation were judged to be politically unacceptable. The democratically elected governments of the world have put themselves in the way of creative destruction but the cost is escalating government debt to GDP ratios. So the key question is not how creative destruction will work in the private sector but how the markets will wreak creative destruction on the private sector through the government debt markets."

As the quote that begins this piece makes clear, those at work in the banks continue to take no responsibility for their actions and indeed may be well placed to benefit from the suspension of normal market mechanisms and the extraordinary degree of explicit government support. But if any other sector in society behaved this way, underwritten by taxpayers who typically enjoy a fraction of their government-backed rivals' remuneration, they would quickly find themselves hanging from lamp-posts by piano wire. The banks would be well advised to divert even a tiny fraction of the sums being allocated toward unwarranted bonuses to some decent public relations advice.

Although Napier's thesis looks apocalyptic, at least for holders of western market government bonds (and it probably will be), the frustrating question of market timing remains. His conclusion is that, on the basis of previous historic examples, equity markets can continue to bloom unless and until inflation approaches a level around 4% and the yields on 10 year Treasuries start to threaten the 5% to 6.5% range. Again, anticipating the timing of such developments is necessarily and inevitably problematic. It seems reasonable to conclude that, in the context of a colossal ongoing asset deleveraging and debt deflation, inflationary pressures will be modest for some time to come. So it is not ***yet*** time conclusively to abandon western government debt for something more genuinely secure. Diversification among high quality debt assets, on the other hand..

Fund managers Eric Sprott and David Franklin in June 2009 ('The Solution.. is the Problem') pointed out that owners of US government debt as of September 2008 would have to buy ***three times*** the debt that they bought in 2008, by September 2009, in order to balance the US accounts. As they observed, given the fragile nature of the economy "it seems frighteningly apparent that a threefold increase in debt purchases by [current bondholders] is a mathematical impossibility." The problem, including timing, is complicated by the involvement of foreign participants, who now account for over 50% of the ownership of US Treasuries. Their involvement goes beyond purely investment objectives, in that their US Treasury holdings are the primary manifestation of their desire to manage their foreign exchange reserves in order to keep their domestic currencies "competitive". Their place in the creditor role nicely diversifies the economic ownership pot, but it also makes the possibility of ultimate repudiation of that debt more likely.

And the threat of repudiation (or default) is no idle possibility. Napier highlights the lamentable history of US debt to GDP ratios over recent years, which now challenges the levels incurred during and after World War II, as the chart below makes clear:

Cited by CLSA Asia-Pacific Markets, 'Solid Ground – How the rally ends', June 2009.

But the moment of crisis may be some way off. The immediate future path of the US dollar may also pleasantly surprise critics. As Napier observes,

"The move to easier monetary policy in the US has not resulted in a collapse in the dollar as the rest of the world has also been forced to much easier monetary policy. A steady dollar reduces inflation risks, encourages foreigners to buy Treasuries and would likely facilitate further quantitative easing if necessary."

At a recent seminar, Napier suggested that the ultimate equity bear market low – triggered by a collapse in US Treasury prices (and a concomitant spike higher in Treasury yields) might not arrive until 2014 or so. In any event, as indicated, the issues of anticipating such timing – not least being influenced by massive political and cultural considerations – are just too difficult to call. But just because a dire situation (US government indebtedness – and let's not pretend that much of the developed world doesn't share that same vast, leaky boat) has become demonstrably more dire over recent years does not mean that the deterioration can persist indefinitely. As Herb Stein once said, if something cannot go on forever, it will stop. When the music finally stops for (US) government bonds, will you really want to be holding any ? Monitoring inflation trends over the coming months and years promises to be more than usually exciting.

Tim Price
Director of Investment
PFP Wealth Management
3rd August 2009.

Email: tim.price@pfpg.co.uk Weblog: http://thepriceofeverything.typepad.com

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 1049/09/SB