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Distant but real

“Senator Joyce said the chances of a US debt default were distant but real and politicians were not doing the electorate a favour by refusing to acknowledge the risk.

“That is the first scenario, which is extremely bad for Australia. The worse scenario is where the US doesn't repay its debt - the \$ 2 trillion in debt it owes to the Chinese, the \$ 1 trillion in debt it has to the Japanese and the \$ 1 trillion in debt to others - and then we are really nailed.

“The outcome is a shift away from the US dollar as the international trading currency and a shift to the Chinese yuan, and China becomes an immensely powerful player overnight.”

- Australian Senator Barnaby Joyce, quoted in The Sydney Morning Herald.

In the ‘Looking Glass’ world in which we are now trapped, we have had to get used to dealing with six, or more, impossible things before breakfast. But few things reveal the rising risk in supposedly safe markets than the marked extent to which the UK economy is in thrall, not just to its bankers, but to its politicians. The banking supertax is one example of a cravenly populist administration desperately lobbying out distractions to placate the mob, and its bluntness and lack of sophistication as a policy instrument are becoming increasingly clear (bankers are an [easy target](#) but [financial advisers](#) per se have a more convincing claim upon clemency). But a cynical pre-Budget report (one that Vince Cable called “a good budget for bingo and boilers”) gives an even more breathtaking sense of a government in utter denial about the hard choices ahead – by tweaking up selective benefits, such as Child Benefit, ahead of a wholesale and inevitable post-election slashing of benefits largesse irrespective of which party wins. In response to the pre-Budget report, bookmaker Paddy Power cut the odds of the UK retaining its ‘AAA’ credit rating from 3/1 to 6/4.

The recent debacle in Dubai has triggered a justified concern among global investors about the risk of sovereign default. But the immediate market reaction, or at the very least the manner of its reporting, jumped to precisely the wrong conclusions. The Wall Street Journal was evidently as confused as many investors when it reported that “crude oil touched a six-week low, gold tumbled, and the dollar climbed as worried investors sought safe havens”. Buying dollars over gold bars is showing a peculiar taste in safe assets. While much of the coverage of Dubai has been lathered with an objectionable mixture of xenophobia and envy, what it actually reveals is that many emerging or ‘alternative’ economies have far more solid foundations, in terms of government finances and other fundamentals, than those of the West, including the United

Kingdom and the United States. As the Australian Senator quoted above rightly points out, the prospect of even a US default is admittedly distant but **it is still real**. Developed governments, of course, tend not to default – but they do so by stealth, by debauching their currencies or by reducing the real burden of their debts by reflation. That, we think, is the primary factor behind the surge in the price of gold: investors globally are making an explicit judgment about the fast-eroding money aspects of the dollar (and other currencies) – whether as a medium of exchange or as a store of value (sic). And one resounding message from 2008 is that we now inhabit a financial environment within which literally **anything can happen**.

As a maxim first used in the 1600s observes, fear of harm ought to be proportional not merely to the gravity of the harm, but also to the probability of the event. This quotation features in the late Peter Bernstein's excellent biography of risk, 'Against the Gods' (John Wiley, 1996). Another insight from this book is one we never tire of repeating, the observation by Daniel Bernoulli that for a wealthy investor, the practical utility of any gain in portfolio value inversely relates to the size of the portfolio. In other words, the wealthy, by and large, should be more concerned with capital preservation than with any capital growth that comes with the meaningful risk of capital destruction. The critical dilemma facing the investor today is that true capital preservation – the truly safe asset – is increasingly difficult to come by. As Anglo-Saxon political risk has increased, so has the inherent instability of Anglo-Saxon government debt, the prices of which we continue to view as being dangerously manipulated by the great experiment known as quantitative easing. And yet the ultimate outcome for the investor in UK Gilts is still not certain. If we are facing a long protracted deflationary balance sheet recession akin to that suffered by Japan, the outcome for a Gilt investor today could still be favourable. But if the market is really only being propped up by the buying of last resort conducted by the Bank of England, the outcome – post QE – could be disastrous. Given the risks, and given the existence of what we would describe as safer alternatives, either within the realm of sovereign debt issued by 'alternative' creditworthy borrowers or within the realm of high quality and high yielding defensive equities, or precious metals themselves, the only conclusion we can reach is that perhaps the smartest move is simply not to play.

The almost universal decline by risk assets during 2008 has led, we suspect, many investors to conclude that diversification is overrated. That conclusion may be profoundly dangerous. While the merits of diversification within an asset class such as equities may be overstated (after a while, a highly diversified equity portfolio starts to resemble an index), the benefits of diversification across multiple asset classes may start to reveal themselves in the very near future. Given the extraordinary uncertainties facing today's investor in a financial world riddled with intractable difficulties, how can one rationally face the future with anything other than a fully diversified portfolio, both by asset type and by individual investment component? But diversification does not demand indiscriminate investment – there is a twin requirement to be highly selective given those same uncertainties (and our natural preference is always for measured conservatism over aggressive speculation).

Notwithstanding the note of caution that this commentary contains, we wish all readers a happy Christmas and a peaceful and, we hope, prosperous New Year.

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