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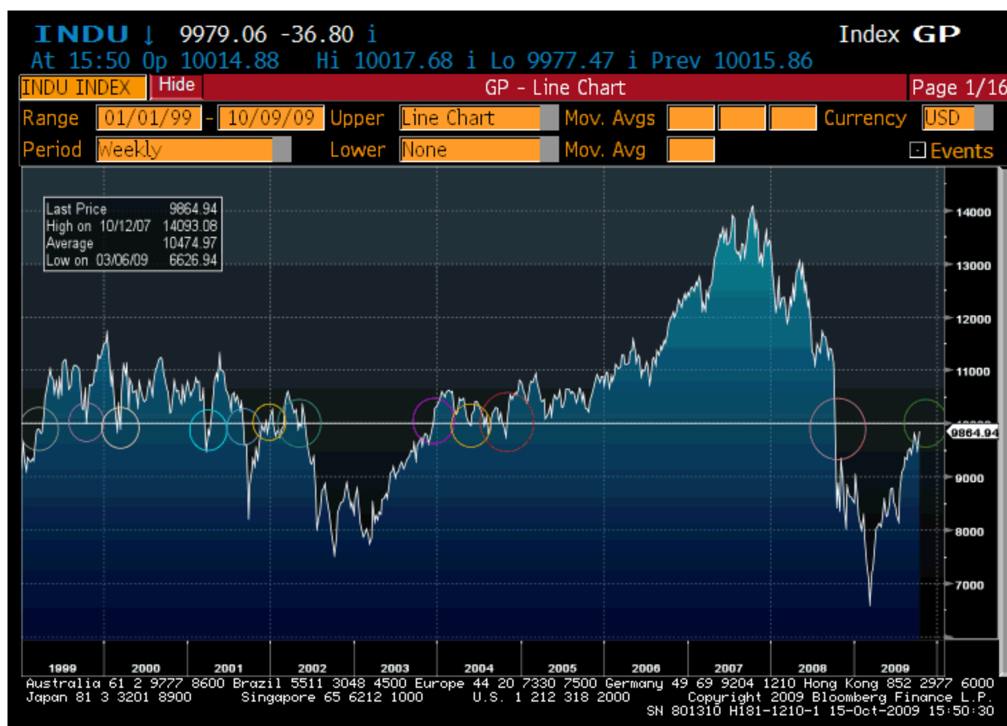
Show me the (real) money

"And you thought you had broken even. If investors had bought gold when the Dow first closed above 10,000 in March 1999, they'd be up almost 280%. Put another way, Dow 10,000 a decade ago "cost" 36 ounces of gold, treating each Dow point as $1. When the Dow revisited that level Wednesday, it was worth only 9.276 ounces of gold. In oil terms, the Dow has gone from 609 barrels to 133."

- The Wall Street Journal on 'Dow 10,000'.

There were somewhat half-hearted celebrations last week when an antediluvian stock index representing 30 companies selected by the editors of the Wall Street Journal crossed the 10,000 level. Again. This stock index, which is most affected by the change in the share price of an 85-year-old computer company, because it's a price-based and not value-weighted index, has been here before – as the graph below shows:

The Dow Jones breaks 10,000.. again..



(Source: Bloomberg LLP.)

There are some things that, the first time you do them, are memorable. But after the sixteenth or seventeenth time, a degree of familiarity (and in this case, boredom) sets in. Breaking through 10,000 for the first time in 1999 was all well and good, even if it meant you were paying all-time highs to own this crude and narrow measure of the US stock market. Breaking through 10,000 ten years later – well, who really cares, other than a narrow coterie of self-obsessed dealers en route to being replaced by machines ?

Over-followed indices aside, equities are not exactly money as such. But what is ? Traditional economics defines money by the following characteristics:

- A medium of exchange;
- A unit of account;
- A store of value.

As a medium of exchange, money facilitates trade on common ground without resorting to barter. As a unit of account, money can be used to assess the value of disparate goods and services. As a store of value, money can act as a medium for longer term savings, not requiring immediate use. But as the western economies struggle to finance gargantuan deficits incurred to support the banking system, there have to be real concerns that an oversupply of fiat currencies – notably the Pound Sterling and the US dollar – will be gradually (or perhaps not so gradually) passed over for use in favour either of harder currencies backed by superior economic fundamentals, or of real assets that have superior prospects of acting as a store of value. This may be just one reason why gold is now trading comfortably above $1,000 an ounce. Paper currencies, particularly the Anglo-Saxon currencies, are in danger of losing at least one or possibly two of their three core monetary characteristics. Their credentials as a 'store of value' are already impaired; with the rise of China and the Asian Tiger economies, the US dollar's hegemony as the pre-eminent unit of account is also called into question. Note, for example, the recent suggestion, subsequently denied, that China, France, Japan, Russia and the Gulf states were planning to replace the US dollar as the currency in which commodity sales would be denominated.

No less a personage than former Federal Reserve chairman Alan Greenspan has spoken of gold's qualities as the ultimate in currency. Speaking to Congress in 1999 he remarked,

"Gold still represents the ultimate form of payment in the world. Fiat money, in extremis, is accepted by nobody. Gold is always accepted."

And Greenspan's previous writings may surprise in their endorsement of the yellow metal.

Goldless investors may be wondering if they have missed the boat. While it is surely better to own a rising asset below $1000 than above, it is also worth asking whether the macro-economic fundamentals are really much better than during the height of the crisis. Particularly in the UK. Take, for example, former FSA chief Sir Howard Davies' comments last week during a London meeting with clients of HSBC:

"The next six months are going to be extremely delicate in the UK.. It is very clear that something dramatic has to happen to control spending, but is the economy robust enough to survive fiscal tightening ?"

And in the foreign exchange markets, conditions can turn ugly very quickly:

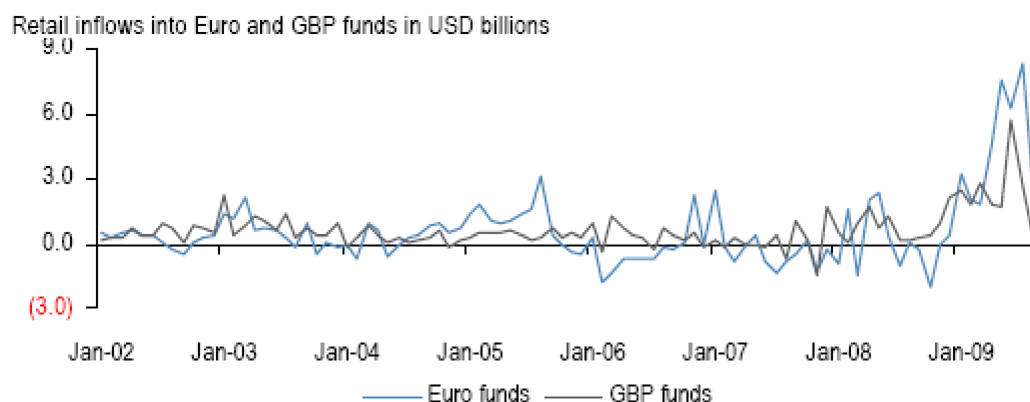
"The pound never stops where you want it to."

So it is probably not a question of whether Sterling continues to depreciate against other currencies, merely to what extent, and with what velocity.

Nor is the problem uniquely British. Hedge fund manager Julian Robertson, when asked last week by the Financial Times what he made of the economic outlook, replied:

"I prefer to run scared through here. I think that if the Chinese stop buying our debt, it is virtually the end of the financial world as we know it.. The conventional thinking is that they will continue buying. But I don't think it's logical to assume somebody will continue to buy our paper which declines in value. Our dollar is declining in value, and it's been pretty shocking over the last four or five months.. The politicians who are so tough on businessmen and so critical – they and the Federal Reserve caused us to be in this predicament.. What really caused me to predict the problems we had in 2007 and 2008 was that we were spending so much and no one was balancing the budget. No family can keep doing that forever, no corporation can keep doing that forever and no nation can continue doing that forever. We did it on all three fronts – and it blew up in our face."

Ground zero for potentially vulnerable financial assets is the bond market – where deteriorating fundamentals in credit outlook and currency collide. Having seen cash deposit rates and Gilt yields sink to the floor, retail investors have flooded over recent months into corporate bonds; there is now evidence that the flood tides are receding:



Source: J.P. Morgan, Thomson Reuters Lipper FMI

That corporate bond inflows are now subsiding is probably no bad thing, given the paucity of yields currently on offer. There is a bigger problem for UK corporate bonds looming, in the form of the FSA's new reforms to bank liquidity rules. The FSA claims that UK banks have just £280 billion of qualifying "liquid assets" versus a shortfall of as much as £620 billion. These rules are likely to trigger substantial sales of (non-qualifying) corporate bonds matched by comparably significant purchases of (qualifying) Gilts over the coming months and years. The best days for the corporate bond market, in other words, may soon be over; while already expensive Gilts may well enjoy another temporary manipulated surge until the market suffocates with supply. Market revulsion at the level of the national debt could conceivably come well before quantitative easing is finally wound down, which makes the investment case for Gilts fraught with issues of a) fundamental attractiveness, b) market timing and c) the potential for ultimate catastrophe.

Happily, there is a compelling alternative. Non-G7 sovereign investment grade debt, exclusively in investment grade terms, and primarily short-dated, addresses each of the visible demerits of Gilts and corporate bonds. There are still opportunities within the credit markets, then – the New Capital Wealthy Nations Bond Fund, for example, which is invested precisely in the type of credit

instruments just described, currently yields around 8% in GBP. That compares with just 2.2% for four year Gilts or around 4.7% for a predominantly investment-grade GBP corporate bond fund. The other attractive dimension to non-G7 credit is currency. UK investors will likely be well served by diversifying away from their local market and avoiding the ongoing rolling disaster which is Sterling.

To conclude, a comment in response to UK journalist Ambrose Evans-Pritchard's recent blog post on the perils of cheap money:

"I have.. bought several thousand pounds worth of gold and silver (coins) in the past 12 months. I store and rotate 100 litres of diesel at all times. I am storing and rotating grain and tinned foods and other stuff on the list of "100 things that disappear first in a crisis". I own two rifles, a pistol, a crossbow, and ammunition for all of them. I'm turning over my garden to an allotment. I now keep hens and will shortly keep bees.

"I am not a survivalist nutter.. My point is that I have lost all faith in our political elite and have profound misgivings about where we're headed in socio-economic terms.

"The global economy is far from fixed; indeed, I believe that the worst is still ahead of us and that most commentators are under-estimating the challenges ahead. As for the UK economy and the outlook for our society, there are some days when I could weep.. I'm simply contingency planning."

That may strike many readers as extreme. But the events of 2008 were pretty extreme, and the stock market recovery to date is not automatically consistent with the recovery of the banking system, less still a recovery in the financing outlook for the global debt mountains. Contingency planning in portfolio terms alone looks like nothing more than simple common sense.

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