The mass escape from reality

"..Built into the speculative episode is the euphoria, the mass escape from reality, that excludes any serious contemplation of the true nature of what is taking place.

"Contributing to and supporting this euphoria are two further factors little noted in our time or in past times. The first is the extreme brevity of the financial memory. In consequence, financial disaster is quickly forgotten. In further consequence, when the same or closely similar circumstances occur again, sometimes in only a few years, they are hailed by a new, often youthful, and always supremely self-confident generation as a brilliantly innovative discovery in the financial and larger economic world. There can be few fields of human endeavour in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present."

- John Kenneth Galbraith, 'A short history of financial euphoria'.

"Sir, The post-interest rate reduction score sheet is not looking good for the Bank of England. The currency has been put under further pressure, engendering the beginnings of cost-push inflation. Instead of putting a further 80p a week into the pockets of mortgagees, many of the biggest lenders have taken the opportunity to improve their margins by actually increasing rates. Pension fund deficits have been put under further needless pressure.

When Mark Carney introduced the rate cut I was inclined to think it merely invoked the classic Peter Cook/Jonathan Miller "Beyond the Fringe" sketch, which has the immortal lines: "We need a futile gesture at this stage. It will raise the whole tone of the war." Now it appears to be much more serious than that."

- Letter to the editor of The Financial Times from Mr Stephen Hazell-Smith, 18 August 2016.

"Sir, We are all watching in horror as the Bank of England destroys the entire pension system of the country, along with the remnants of a savings culture that was already tough to instil in the younger generation. Conventional economics suggests that the radical policy is not working because rates are not low enough. Might I suggest another reason?

The BoE has repeatedly implied that rates will remain at these sorts of levels for an indefinite amount of time. That means that if a business owner wishes to increase capacity, there is no urgency to do so, as he can wait and still be able to access cheap credit. If the Bank were to specify a date when rates will rise and not make it too distant, then there would be an incentive to act now.

Give us all a date when this madness will end, and people will spring into action. After all, "buy now while stocks last" has always been a good catalyst."

- Letter to the editor of The Financial Times from Sally Macdonald, 15 August 2016.

From the vantage point of the great bond bubble of 2016, the first dotcom insanity now looks like an oasis of common sense. With the benefit of hindsight, it was clearly unwise to give Pets.com, for example, an online seller of pet supplies whose spokesperson was a sock puppet, a market capitalisation of $121 million, but then hindsight's a wonderful thing. The company had its IPO in February 2000, missing the peak of the market by just a month, and within 270 days it was gone altogether.

In defence of the first wave of dotcom investors ("the pioneers get the arrows; the settlers get the land"), how ***should*** you price a business which might disappear within months, but which might also achieve global success in the fullness of time and turn a commensurately enormous profit ?

On that score, by comparison with bond "investors" today, the first dotcom investors were being almost comically conservative. An early stage technology venture has the potential to generate eye-popping returns. Dell Computer, for example, during the decade of the 1990s delivered total returns to shareholders of 91,863%.

Anybody buying 5 year Japanese government bonds today, for example (with Japan's government debt to GDP ratio at 230%), and holding to maturity, will not make 91,863%. The yield to maturity on these bonds is ***minus*** 0.2% **-** a guaranteed loss, before any impact from inflation or currency movements.

How to account for the behaviour of bond "investors" in 2016 and their collective participation in a mass escape from reality ?

Elliott Management's Paul Singer provides a simple explanation: the global bond market is broken. "Everyone is in the dark," he writes in a letter to investors; "Experience doesn't count for much, and extreme confidence could be fatal"; "the ultimate breakdown (or series of breakdowns) from this environment is likely to be surprising, sudden, intense, and large."

But we're not trading bonds (or anything else, for that matter). We are, however, indebted to Mr J. Escott for having introduced a new word into our vocabulary: ***apophatic***.

An investor is behaving *apophatically* if he is expressing macro-economic concerns by avoidance rather than specifically betting on a seemingly inevitable outcome.

Chances are you've experienced someone speaking *apophatically* – apophasis being a rhetorical style particularly popular with politicians. The US presidential candidate Donald Trump is a past master at it. For example, in 2015 he said of his rival and the former CEO of Hewlett-Packard, Carly Fiorina,

"I promised that I would not say that she ran Hewlett-Packard into the ground, that she laid off tens of thousands of people, and she got viciously fired. I said I will not say it, so I will not say it."

Used rhetorically, aphophasis is clearly a sneaky manoeuvre.

But used in an investment context, it's quite down-to-earth. It essentially means: if you don't really understand the rules of the game or if the price of something seems unsustainably high, don't try and benefit by speculating (either by selling it short *or* buying it) because that's too dangerous – it's easier, and altogether less risky, just to stop playing that game, and go play a different game somewhere else.

The last quarter century of ever-shrinking Japanese bond yields has been the widowmaker trade *par excellence*. It would seem that where Japan has led the way, the rest of the world is finally playing catch-up.

In a world where the bond market feels irretrievably broken, which investments still have fundamental appeal ? We continue to identify three specific types. One is systematic trend-following, which offers the potential for meaningful portfolio insurance in a world where systemic risk is in the ascendant. One is monetary metal, with reassuring scarcity in a world where money, money-printing and over-priced money substitutes are becoming painfully commonplace. And one is defensive value in the stock market.

J.K. Galbraith, again:

"The only remedy, in fact, is an enhanced scepticism that would resolutely associate too evident optimism with probable foolishness and that would not associate intelligence with the acquisition, the deployment, or, for that matter, the administration of large sums of money. Let the following be one of the unfailing rules by which the individual investor and, needless to say, the pension and other institutional fund manager are guided: there is the possibility, even the likelihood, of self-approving and extravagantly error-prone behaviour on the part of those closely associated with money."

In other words, don't expect most professional fund managers to save you – whether of bond funds or anything else. It seems increasingly likely that they are the ones causing most of the problems.

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