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The geeks shall not inherit the earth

"I am indeed rich, since my income is superior to my expense, and my expense is equal to my wishes."

- Edward Gibbon.

The brief of Eric Beinhocker's outstanding 'The Origin of Wealth' (Random House, 2007) is to address the questions: what is wealth ? How is it created ? And how can we create more of it ? But it also, almost incidentally, explains how the current banking crisis happened.

The answer comes on page 30, and the culprit is traditional economics, and more specifically, the French serial failure Léon Walras. Having been twice rejected from the École Polytechnique, Walras went on to fail as an engineer and then as a novelist. But his real legacy is the damage he wrought upon economics as a serious discipline. Living in an era of great scientific progress, Walras sought to bring to the study of economics some of the disciplines of mathematics and physics. But in doing so, and imposing equilibrium theory from physics onto economics, Walras vastly oversimplified economics' modelling of the real world.

Walras may not have been alone. Beinhocker points out that he was "not the only economist during his era raiding physics textbooks in search of inspiration"; the British economist William Stanley Jevons is also cited for borrowing from the theories of gravity, magnetism and electricity in an attempt to turn economics into a mathematical science. The critical problem stemming from this cross-disciplinary mongrelisation of ideas is that the real world is not easily reducible to simple equations. And it is now abundantly clear that overmuch faith in economic modelling and financial theory can have catastrophic real world results.

Prior to the financial debacle of 2007 - ? , probably the finest example of academic hubris leading to disaster came in the form of Long Term Capital Management, the hedge fund demolished by its own Nobel Laureates. It is said that during its fund raising of late 1993, a young trader at insurance company Conseco bridled at the idea that LTCM could reap massive returns from the – highly efficient – US Treasury market. Future Nobel Prize winner and co-inventor of the Black Scholes option pricing model, Myron Scholes, archly responded:

"You're the reason. Because of fools like you we can."

It is also said that an ingratiating Merrill Lynch marketer once asked Scholes which he had more of, money or brains. Scholes' response:

"Brains, but it's getting closer."

But who turned out to be the greater fool, when LTCM – whose risk aggregation model predicted that the fund was exposed to potential losses no greater than $35 million – lost $553 million in a single day, using leverage of 200-1 ?

The LTCM collapse arguably sowed the seeds for our current crisis, to the extent that the bailout orchestrated by the Federal Reserve underlined the concept of the 'Greenspan put' – that the US central bank would always ride to the rescue if markets ran into trouble – and that the same bailout also reinforced the principle, since stress-tested to perfection, that financial institutions could become too big to be allowed to fail. And as Stephen Rhodes nicely puts it in his review of Roger Lowenstein's account of the LTCM failure, 'When Genius Failed' comprises

"a cautionary tale that the global financial markets would do well to reflect upon – the potentially combustible combination of easy credit, weak derivatives oversight and the cult of personality."

One key difference between 1998 and 2008 is that LTCM was a hedge fund, and Lehman Brothers, for example, whose failure triggered a comparable near meltdown in the global financial system, was an investment bank, albeit a second tier one. And it is truly galling that while hedge funds, by and large, have learnt many of the lessons of LTCM (notably, avoid hysterical leverage) and the banks have not, and while hedge funds have received not one penny in state assistance, it is they that find themselves facing the threat of regulation into oblivion. Those that survive will no doubt remember to boost the level of their political donations next time round.

But we are where we are. And in the case of Cassandra, we are moving house. As this trenchant observer of financial markets notes, there may be something in common between the vast accumulated detritus that surfaces when moving home and the perilous state of the western economies:

"Analysing how this happened without my noticing, I begin to suspect that there is something allegorical in my predicament, both with respect to The Credit Bubble in general, and the erosion of America's fiscal position, and household balance sheets in particular. For just as I never set out with a plan to mindlessly consume and acquire, so too did America not consciously embark upon a credit-induced death-wish, nor the State and Her households conspire to burden themselves with untenably serviceable quantities of debt. Incrementalism was the path. Mañana, mañana, mañana was the mantra of denial that insured the difficult choice, the painful option, the road less travelled, was rarely contemplated let alone set out upon. Just as one doesn't become hugely obese by the pull of a rip-cord, the extension and multiplication of credit is not instantaneously conjured. It is a slow-motion result accumulating from innumerable small decisions, each not life-threatening and reversible in themselves, but when conjoined, and embedded in feedback-loops, resulting in veritable disaster, be it fiscally, in one's waistline, or, in the accumulation of stuff."

And the question of the day, not to say year, is: is it really all over ? Or as Cassandra voices it,

"Has the denoument of the crisis passed, or is this merely the eye of the storm ? I am but an economist with a very small "e", however.. the question of what is likely to appear to be normal in hindsight is not (if this is The Big One as I believe it is) what is popularly perceived. "Peak Credit" has come and gone, and with it, the Era of Stupid Loans passed - for this generation anyway.. IF the era of Stupid Loans is finished, there will be no recovery. There will be precious little inflation, and it is likely deflation will persist.

"I want to be bullish. I want asset prices to already be south of some long-term equilibrium, and be ready to rise. It would be less painful for The People. But with employment shocks still to ripple through the chain of dependencies, household balance sheets compromised, continued real-estate indigestion, our position between a fiscal rock & a hard place, and continued financial sector deleveraging, we collectively are the place that I've just been. We collectively are just beginning to sift through our s**t - mentally sizing up what's important, what to take and what to leave. We are just beginning to realize that tough choices lie ahead - in all facets of life. We are just beginning to understand that these choices do not include 5-litre Cadillacs, absurdly over-applianced kitchens, or $5 iced-frappucino lattes."

In the aftermath of 'The Great Moderation' (and of course the 'Great Credit Bubble'), we are now trying to make sense of and navigate through what Pimco is calling 'the new normal'. Ideally, in Churchill's words, the new world order would involve finance being less proud, and industry more content. One thing seems clear. Things will never be quite the same again. Western businesses in particular will be well served by moderating future expectations. That goes for investors too. For a realistic sense of likely investment returns, take whatever your earlier aspirations were, and shrink them.

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