36 South Views

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Linearism and the hubris of King Canute

I am currently reading the Fourth Turning by William Strauss and Neil Howe. Some of the ideas in the book have rung loud bells in my mind.

The predominant one is "linearism", the desire to take away the cycle and replace it with a straight line.

Down cycles are painful, bring destruction, expose weakness and create uncertainty.

But as in nature, the down cycle – the fire, the flood, the storm – is essential to bring balance and spawn new growth amongst other things.

In economic and financial cycles, central banks, like King Canute who, in the 12th century, ordered back the waves and the tide, have ordered back the down cycles and economic downturns with a stroke of their money printing pen.

Theodore Dalrymple puts it well: "Political power or office often gives those who possess it the illusion that they control events. That, after all, is the reason why the story of King Canute retains, and will always retain, its relevance to the current political situation."[1]

William Strauss and Neil Howe agree: "The great achievement of linear time has been to endow mankind with a purposeful confidence in its own self-improvement."[2]

However put off the harm long enough and the consequence, when it arrives, will be **exponentially** greater.

The oft-quoted Yellowstone effect will preside. I.e. having successfully micromanaged the Yellowstone's forests, no significant fires were recorded for many years. The underbrush built up, trees grew closer together and the conditions became more and more fragile. When a fire eventually took hold it was catastrophic.

And to make things more interesting, everyone now believes that economic and financial down cycles are a thing of the past, banished by Financial Fire Departments AKA central banks.

And so people feel comfortable building their wooden homes in or around the forest.

In 2007 there was about 130 trillion notional outstanding in options[3]. To put it in perspective, that is bigger than the global bond market[4].

When the GFC erupted there were huge losses and gains but not much money changed hands as they were largely over-the-counter derivatives, destined to be settled only at expiry of the option. If there was any margining it was in the favour of the banks.

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[1] https://en.wikipedia.org/wiki/King_Canute_and_the_tide

[2] Strauss, H. & Howe, N. (2009) The Fourth Turning: What the Cycles of History Tell Us About America's Next Rendezvous with Destiny, Crown/Archetype; p 11

[3] Exchange traded options value accessed at https://www.bis.org/publ/qtrpdf/r_qa0803.pdf; OTC options value accessed at https://www.bis.org/publ/otc_hy0811.pdf

[4] Accessed at https://www.sifma.org/wp-content/uploads/2017/08/US-Fact-Book-2018-SIFMA.pdf

Today there is 120 trillion outstanding in options[5], over half in OTC, but regulations have changed, **all** uncleared OTC options must have two way margining and the seller must post margin on a daily basis to the option buyer no matter which bank is involved.

What does this mean?

In a big move in the financial markets, significant money must be found for margin, making the chance of a liquidity crisis not only greater but in my view inevitable.

Leverage is glorious, debt is ubiquitous and consumerism as an ideology for GDP growth looks strong.

But things are their weakest in the financial markets when they appear their strongest.

We can't predict the spark that starts the fire, the snowflake that causes the avalanche or the butterfly's wing that sets off the tornado but I am willing to go out on a limb and say that conditions are ripe and the price of "insurance" is low.

Central banks have created a linear economic and financial cycle (at least nominally) that has only one direction… UP … to a glorious future of wealth and prosperity for all.

And with all the apparent success that that has brought, so too has the negative second and third order consequences, i.e. zombie companies, wealth inequality, capital misallocation and biased economic behaviour, i.e. share buybacks – to name a few.

Fragility is present in plain sight but ignored.

So for now we must be content to hold the avalanche hedge, the fire hedge and for good measure the ticket on Noah's boat.

Low probability events priced for impossibility … in an environment that becomes increasingly likely every day.

There is a tide in the affairs of men,

Which taken at the flood, leads on to fortune.

Omitted, all the voyage of their life

Is bound in shallows and in miseries.

On such a full sea are we now afloat.

And we must take the current when it serves,

Or lose our ventures. [6]

Disclosure

[5] Accessed at https://www.bis.org/statistics/bulletin1903.pdf#page=256
[6] Shakespeare, W. *Julius Caesar,* Act IV, scene III