

36 South Views

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The road less travelled

Two roads diverged in a wood and I - I took the one less travelled by, and that has made all the difference.

Robert Frost

In 2008 central banks took the road less travelled, an unprecedented bailout of the financial system precipitated by the implosion of primarily the property and concomitant financing bubble in the US.

Arguably a great move...the world would have been a starkly different place if we had a great reset in 2008.

Staying on the road less travelled for 11 years is entirely less obvious. It kicks the can down the road and has introduced a grey swan overpopulation that could rival the rabbit plague in Australia! (Grey swans are risks which are inherently knowable in advance unlike black swans which are unknowable (within reason) in advance.)

My main objection is that it introduces biases for behaviour which begets negative second order consequences – admittedly down the road.

Governments get pretty much free financing – tendency to overspend.

States, municipals and corporates ditto – tendency to overspend/over-lever i.e. buybacks.

Individual spenders get very cheap financing especially on property and individual savers get nothing, forcing them into lower quality risk assets or low cost products i.e. passive investing.

Financial assets get repriced upwards – zero financing for infinity horizon makes financial assets tend to infinity. You give me zero financing for infinity and I will buy any Monet for a billion dollars!

The counter-arguments are well known:

- Everyone needs to spend to keep the economy growing. My wealth is growing nominally - that cannot be bad, surely?
- I can afford a better house than before!
- My pension fund is now funded again. Sort of.
- We need to combat deflation.
- Inflation is dead.

If all this was true, why haven't governments for the last 2,000 years moved interest rates to zero and simply funded themselves for free?

History shows they have tried repeatedly in various guises with a 100% failure rate, the Mississippi bubble being a poster child.

So I favour the road well-travelled to this road... just as I favour the strategy of ants over grasshoppers.

But travel this road we have and now we must deal with reality or reality will deal with us.

"Our view of reality is like a map with which to negotiate the terrain of life...If the map is false and inaccurate, we generally will be lost...Their maps are small and sketchy, their views of the world narrow and misleading...they feel certain that their maps are complete and their Weltanschauung is correct (indeed, even sacrosanct), and they are no longer interested in new information."

M. Scott Peck

The reality is, from my perspective, that this road will be travelled until something comes along to precipitate ubiquitous awareness that this road can lead nowhere we as a society want to be.

The below paragraph in an article by Michael Burry sums up the current geo-financial landscape:

¹ Peck, M. S. (1978). *The road less traveled: A new psychology of love, traditional values, and spiritual growth*. New York: Simon and Schuster.

"Central banks and Basel III have more or less removed price discovery from the credit markets, meaning risk does not have an accurate pricing mechanism in interest rates anymore. And now passive investing has removed price discovery from the equity markets. The simple theses and the models that get people into sectors, factors, indexes, or ETFs and mutual funds mimicking those strategies -- these do not require the security-level analysis that is required for true price discovery."²

Misallocation of capital in our biggest financial markets i.e. bonds and equities - very succinctly put.

Further along the road less travelled one should see the second order consequences appear...one, two or all and more I haven't thought of...

- Financial asset inflation - extreme wealth divide as the rich get rich, the middle class gets decimated and the poor get poorer leading to populism, civil unrest or even outright revolution.
- Extreme volatility in foreign exchange markets as governments have effectively fixed interest rates, the markets must price discover through the exchange rate.
- Absence of diversification and hedges – with passive investing, everybody is correlated with the same portfolio. And with bonds approaching zero it is unlikely that there will be a hedge ex volatility assets in the event of severe equity or bond risk aversion.
- Emergence of real asset inflation – substantial equity and bond market sell-off, precious metals rise.
- Rise in geopolitical tensions as governments "beggar thy neighbour" by attempting to keep their own spluttering economies alive.
- Emergence of stagflation.

That almost sounds familiar?

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² <https://www.bloomberg.com/news/articles/2019-09-04/michael-burry-explains-why-index-funds-are-like-subprime-cdos>