

# 36 South Views

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## The precipice of history

Our macroeconomic view is that we are witnessing a long cycle in the ideology of consumerism as an engine for world prosperity as measured by GDP.

This ideology ran out of capital in about 1987 and has been relying on credit ever since; household credit and mortgages for households, government debt for governments, municipal debt for municipalities, etc., etc.

Credit in turn relies on confidence in the ability to repay both the interest and the capital.

2008 was the watershed year where the markets signalled that the extension of credit, especially in real estate, had reached some sort of illogical limit and began to mean revert. The snap back was so great, governments and central banks alike panicked and underwrote most of the existing credit as well as driving rates to zero thus stopping the great credit bubble implosion. In fact it did such a good job it has allowed scope for even more credit extension. Anything to keep the ideology of growth for growth's sake alive.

In this way, central banks have created the faith in the ability to repay capital and interest as they ultimately own the printing press and could in theory cover ANY shortfall.

The second order effect of driving interest rates to zero is that savers are corralled into investments where, historically, the risk is much higher than the commensurate reward. E.g. equity markets, high yield bonds, autocallable structured products.

And here we sit, on the precipice of history.

Interest rates remain near zero thus leaving central banks with little freeboard should markets swoon again.

China, the manufacturer of most of the world goods, is "seemingly" contracting rapidly in spite of massive credit extension over the last seven years. "Seemingly", because the official stance does not seem to point to massive contraction but commodity prices do.

Savers are being enticed into instruments like structured credit, which in our mind is just someone else's hypothecated debt. At the same time, they have been actively discouraged from investing in real assets like commodities which have fallen 50% plus in price on average. (Institutional investment in commodities is at multi decade historical lows.)

Where to now?

A lot of commentators speculate on either inflation (less of these commentators around now) or deflation (the common view).

We personally have witnessed both inflation and deflation CO-EXISTING in an economy and believe that this will happen to the world economy in the near future.

Why?

Governments have gone all-in in their efforts to curb deflation and will meet any episodic deflationary pressures with all the tools at their disposal, i.e. lowering interest rates, paper money creation, and credit extension.

All of the above will lead to further financial asset valuation increases but will do little to curb the deflationary pressures in the REAL economy.

Thus we will see the 'Greenspan put' at work in the financial markets; interest rates will stay closer to zero than normality because the real economy will not be able to withstand higher rates as it will remain in a deflationary

cycle. Any episodic downdraft in asset prices will be met with direct intervention by central banks. Credit will be extended directly or indirectly by governments and central banks.

Sleep, rave, repeat – until the faith in “sound money” has been dissolved.

This is nothing new; my grandmother earned 7 pounds a YEAR as a nurse in England at the turn of the 20<sup>th</sup> century.

What is new is the scale and the acceleration rate.

If history is any guide, this will lead in the short to medium term to hyper-stagflation.

Charming....

PS Ignorance IS bliss.

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