36 South Views

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Potemkin village

> In politics and economics, a Potemkin village… is any construction (literal or figurative) built solely to deceive others into thinking that a situation is better than it really is. The term comes from stories of a fake portable village built solely to impress Empress Catherine II by her former lover Grigory Potemkin during her journey to Crimea in 1787. While modern historians claim accounts of this portable village are exaggerated, the original story was that Potemkin erected phony portable settlements along the banks of the Dnieper River in order to impress the Russian Empress; the structures would be disassembled after she passed, and re-assembled farther along her route to be viewed again as if another example.[1]

I am immensely suspicious of the rally which occurred between Christmas and New Year.

Mnuchin called the banks to see if they had enough liquidity when the market was down 15%!

All the politicians, economists… damn near everyone rallied to the call to restore calm in the markets. I say again: at 15% down?

The equity market is now running on fear, not greed and I think any rally will see the smart money distribute to the stupid money and the bear market will resume.

It reminds me of the Potemkin village described above, where the 'powers that be' conspired to create an illusion of prosperity in order to give the impression that things were not as bad as they seemed (i.e., working the market up whilst everyone is on holiday).

The idea being that when investors get their 401k statement next month, they won't stampede for their phones to put in sell orders, panicking in the knowledge that they now definitely don't have enough to retire on.

US and China moved very quickly to manufacture good news. It can be difficult working out facts from politically manufactured realities!

The question on my mind is why equity valuations are so goddam important to politicians now.

My take is that the whole economy is simply a confidence game now. Without confidence, people start to save (God forbid!) which by default means they stop spending. Consumer spending is almost 70% of the US GDP[2].

Also, credit starts to become an issue again. Credit IS confidence!

The amount of debt in the world has far surpassed 2008[3]. The financial system is much more fragile than 2008. The quality of debt is much worse than in 2008 because of the 'reach for yield at any cost' which in turn was created by low interest rates.

Government borrowing rates can be 1% but without normalized credit, ordinary people have to pay way more than that.

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[1] https://en.wikipedia.org/wiki/Potemkin_village
[2] https://www.thebalance.com/consumer-spending-trends-and-current-statistics-3305916
[3] https://www.cnbc.com/2018/07/11/global-debt-hits-a-new-record-at-247-trillion.html

Also, governments need confidence to stay in power. They are blamed for the poor economy.

The only upside to a falling equity market is that governments get to fund their borrowing at lower rates because the Fed keeps interest rates low. And they like that more than anything! US government interest payments are on track to exceed defence spending in the next few years[4]. And to put that in perspective, US defence spending, the largest in the world, is nearly as great as the combined defence spending of the next 8 largest countries![5]

Governments are essentially self-serving and are fuelled by power and money. Power is gained by getting the most people paying taxes in a vibrant economy or dependent on them for handouts in a bad economy (which, hopefully they are not blamed for).

But handouts require money which no-one really has except the top 1%.

So they borrow from our children and their children i.e. from the future.

And that borrowing is out of control.

The US need to refinance something of the order of 7-8 TRILLION dollars in the next 12 months[6].

That dwarfs any number I have ever seen. To put it in perspective, Russia blew up in 1998 for 160 billion US dollars[7] which is what the US over spends every month or so now[8].

How much longer can the US keep borrowing hundreds of billions a year from the rest of the world to fund its twin deficits?

How much longer can the US treasury keep on borrowing to fund the government's deficit of just under 1 trillion a year[9]?

How much longer can consumers keep on spending more than they earn and borrowing the difference?

The Fed is stuck between a rock and a hard place. If equity markets tank, the 'wealth effect' makes consumers stop spending which in turn lowers tax revenues which increases the need to borrow more. But if interest rates are too low the demand for debt is just not there, not at the level of supply which needs to come to the market. Especially true for overseas buyers who will look elsewhere for yield especially if the US dollar starts declining.

If the Fed feels they need to increase interest rates to attract buyers, the debt-fuelled binge on equity and property markets will move swiftly into reverse.

If the equity market goes, there goes credit and politicians get in the firing line soon after (not before they have blamed bankers and hedge fund managers!).

Therein lies the problem.

I haven't even discussed the pension crisis and demographics yet.

And so there is a concerted effort to keep the Potemkin village looking wealthy and prosperous and safe!

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4 https://www.nytimes.com/2018/09/25/business/economy/us-government-debt-interest.html
5 https://en.wikipedia.org/wiki/List_of_countries_by_military_expenditures
6 https://www.theinvestorspodcast.com/episodes/stocks-bonds-currencies-commodities-luke-gromen/
7 http://news.bbc.co.uk/1/hi/business/209216.stm
8 https://www.thebalance.com/us-deficit-by-year-3306306
9 https://www.thebalance.com/us-deficit-by-year-3306306

From where I sit, December was the iceberg which ripped the hole down the side of the equity markets.

The band is still playing and everyone is concerned, but not panicking … yet.

Only the Captain.

Disclosure

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