

36 South Views

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Who is delusional?

The road less traveled, by M. Scott Peck¹, starts with a simple but poignant line...

"Life is difficult. This is a great truth, one of the greatest truths."

Running asymmetrical crisis funds in 2019 was difficult...and painful.

For the last ten years, central banks have interposed themselves as Greek gods, dispensing money and liquidity whenever investors feel nervous or valuations start to look vulnerable. Like ill principled parents who give in to every one of their children's whims at the first sign of them 'throwing their toys out of the pram'.

"Most of us are not so wise. Fearing the pain involved, almost all of us, to a greater or lesser degree, attempt to avoid problems. We procrastinate, hoping that they will go away. We ignore them, forget them, pretend they do not exist." Some of us will go to quite extraordinary lengths to avoid our problems and the suffering they cause, proceeding far afield from all that is clearly good and sensible in order to try to find an easy way out, building the most elaborate fantasies in which to live, sometimes to the total exclusion of reality. In the succinctly elegant words of Carl Jung, "Neurosis is always a substitute for legitimate suffering."

This is what the central banks have done, taken extraordinary lengths to avoid legitimate suffering required from our cumulative financial excesses in the last 30 years by printing money, extending credit and thus giving the illusion of wealth and stability.

When the casino gives free credit, don't all the punters look like winners?

Responding appropriately in 2019, equity markets went on a tear and posted significant returns.

Bond markets which normally negatively correlate to equities i.e. yields should have backed up higher and prices down, also posted strong price performance thus providing a bonanza year for traditional fund managers.

This is no small part due to central banks buying a significant amount of what Treasury had to sell to fund their respective governments.

Other hedging strategies look stupid, costly and wrong.

And all this happened without seeming consequence, i.e. real inflation.

So the big year end question is...

Who is delusional?

Is reality that central banks can continue with impunity and thus hedging is not necessary or is hedging more critical now as reality is inevitably coming to bite the central bank policy back?

We think the latter...and we are not alone (although nearly!). Why are central banks acting so (seemingly) irresponsibly?

¹ M. Scott Peck, *The Road Less Traveled: A New Psychology of Love, Traditional Values and Spiritual Growth*

We believe that the answer lies in the propensity for governments worldwide to fund more and more debt. According to Luke Gromen, the US needs to refinance 11 trillion dollars this year, 70% less than 6 months tenor! They simply cannot afford higher rates and thus have used every crisis to drag interest rates towards zero. This allows governments to fund bigger deficits and to keep their borrowing costs down. This in turn has driven equity and bond valuations to nosebleed levels.

“Building the most elaborate fantasies in which to live, sometimes to the exclusion of reality. . . but the substitute itself ultimately becomes more painful than the legitimate suffering it was designed to avoid. The neurosis itself becomes the biggest problem. True to form, many will then attempt to avoid this pain and this problem in turn, building layer upon layer of neurosis.”

The substitute will ultimately become more painful...the second order consequences will be more painful to society than if we had simply addressed the problems directly.

We believe that this is taking the form of wealth inequality and a rise in geopolitical tension. It could easily take the form of war, real inflation, volatility and significantly lower equity and bond prices.

In our 17 years, we have never seen so many investors on the same side of the boat and we have never seen such high potential for a crisis to emerge which the central banks cannot get in front of e.g. a currency or liquidity crisis. So we can commiserate with clients who are getting hedging fatigue in the face of such unanimous opinion on the direction and strength of markets and the poor performance of non-bond hedging strategies.

We are happy that most clients have enjoyed great performance in their traditional portfolios and probably the last thing they want is a crisis of any sort. But, all we will get in the end is reality, not the fantasy, and if the cost of preparation of that inevitability is cheap enough, it should be undertaken.

And yes the bull market bubbles are mature by many metrics, and, volatility, the most consistent and efficient hedge is currently cheap. By staying the course and hedging appropriately I believe they will, like lifeboats in a storm, prove their worth.

Disclosure

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