



Sound money

We have forgotten the reason we had a gold standard and independent central banks. This was to protect ourselves against the penchant of governments for borrowing/printing to finance themselves at their citizens' expense.

History has shown us again and again what happens when we abandon the gold standard and/or central banks lose their independence and bow to the wishes of the incumbent governments.

On such a full sea are we now afloat¹...

We are so deep in the delusion that all that is required is more credit expansion i.e. borrow from our children's children, and we will successfully whistle past the graveyard without any negative second order effects.

The debt pyramid is now so large that an unwind is all but impossible even if there was a political will to do it, which there isn't, so it is to infinity and beyond with monetary and fiscal expansion.

But governments couldn't carry on down this path without the complicit aid of central banks inexorably dragging interest rates to the zero bound and beyond, making credit effectively free.

Interest rates were supposed to regulate the supply and demand of capital and provide a hurdle over which all future financial decisions must jump to be considered worthy but I suppose when there is infinite supply it loses its purpose.

So low interest rates have corralled most investors into the highest risk, lowest yield abattoir they can find.

But like driving cattle in an electrical storm, there is always fear there. Global illiquidity, the potential margin calls on derivative positions, the narrowing of the equity leadership, and the geopolitical risk amongst others.

How do you dance when the party is in full swing yet stay close to the exit door?

The nature of black swans is their cunning ability to disguise themselves in full view in good times and yet become painfully apparent in hindsight.

And funnily enough the black swan antidote is lying in plain sight as well!

Unless we are remarkably prescient we cannot know what form or even in what asset class the black swan will emerge. Will it be an equity crisis? A bond crisis? A currency meltdown? All of the above?

There is one panacea, one antidote which sits in plain sight which covers most black swans.

Volatility.

Volatility can be counted on to go up when any sort of financial crisis occurs, be it equity, bond, currency or commodity. It is often the cheapest portfolio hedge when the markets are at their most complacent i.e. when volatility assets are marked down to extreme levels in the absence of any fear of uncertainty.

Given the extreme fragility of the financial markets, it offers the get-out-of-the-abattoir-relatively-unscathed card at a very compelling price.

But like experience we will only value it highly AFTER the point in time when we needed it most.

Disclosure

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¹ <https://www.sparknotes.com/shakespeare/juliuscaesar/quotes/page/4/>