36 South Views

BY RICHARD "JERRY" HAWORTH

The doomsday machine

Somebody was courageous enough to invite us to speak at a conference and we took this opportunity to talk about 'the doomsday machine' – the global debt bubble – and its potential to ruin the lives of 7000 million people. (We made sure all sharp objects were removed from the conference centre beforehand.)

We also talked about the role of derivatives and volatility in all of this.

It is always interesting for us to do this kind of thing because we are forced to ask ourselves WHY some things are like they are:

- Why has the attitude to debt changed 180 degrees in 100 years?
- What is the role of derivatives?
- What is the role of volatility?
- Why not do away with both derivatives and volatility?

Surely the lessons of 2008 showed us that both derivatives and volatility are bad and also have the potential to destroy the financial system taking the real world with it?

The answers we came up with (and they may well be wrong but like they say, often wrong but never in doubt!) are surprising…

Derivatives and volatility are messengers, couriers, if you will, of vital information: the current price and value of everything. If this was not extremely valuable to an efficient economy then communism would have worked perfectly. Accurate, timely information allows the market to allocate resources efficiently and to provide timely feedback. They allow the economic 'machine' to self-correct along the way, a kind of self-healing mechanism.

Timely feedback is incredibly important as it allows the economy to make many small adjustments so as to avoid one big adjustment later on. Would you rather jump off a two foot wall a hundred times or a two hundred foot wall once? The total height jumped is the same but the consequences are totally different! Same too for the economy.

Central banks however have let price equilibrium post 2008 get out of whack by supressing interest rates and, by second order effect, volatility, amongst other things, for too long. They have deferred making small adjustments based on accurate feedback and now the economy faces a 50 foot chasm from where it is to where it should be. If they jump now they face injury, later… serious injury… If they defer for too long they face certain death.

If interest rates were to free float to where the supply and demand of capital really is (without central banks providing basically free credit), the financial system would all but collapse. The ensuing liquidity crisis would take interest rates to levels not seen in decades and asset prices would collapse in sympathy. Central banks will never willingly let this happen so they will simply debase the value of money by adding more of it – 'whatever it takes'.

China is the worst offender in the last 5 years according to the 2014 McKinsey report[1]. They added 20 trillion of debt in that time, more than the US government debt and 10% of GLOBAL debt. Debasing the money works until it doesn't. The moment the man in the street senses this debasement, he seeks real goods or alternative currencies which are deemed a safe haven i.e. the Swiss franc and New Zealand property. And then, like a bridge in an earthquake, the economy starts to buck and turn, getting successively worse until something snaps. No wonder we looked down on the audience and saw the look of absolute disbelief as if a doomsday prepper had stumbled into the wrong convention.

Sorry, sir, the Bear Grylls Survival Convention is just down the hall…

[1]http://www.mckinsey.com/client_service/media_and_entertainment/latest_thinking/global_media_report_2014. Accessed 17 May 2015.

DISCLAIMER

36 South Capital Advisors LLP is authorised and regulated by the Financial Conduct Authority (FCA).

This document is for professional investors and qualifying investors only and no other person should rely upon the information contained within it. Prospective investors will be required to certify they are qualified investors upon application and certify their awareness of the risks involved in the investment and, in particular, the inherent risk of losing sums invested. Offering documentation and fund literature is only available upon request and not available on the 36 South Capital Advisors LLP's website. As part of the subscription process the fund administrators check the eligibility of investors.

Unless otherwise stated, the statements, views and opinions expressed in this document are those solely of 36 South Capital Advisors LLP.

An investment with 36 South Capital Advisors LLP will involve a significant degree of risk, which each prospective investor must carefully consider.

Past performance is not necessarily indicative of future results.