



Stability begets instability

Minsky was an economist made famous for his financial instability hypothesis.

Basically he proposed that stability begets instability and vice versa and gave cogent reasons why this is so. We have directly observed this for 30 years in the behaviour of implied volatility or the perception of future volatility by investors, the main driver of value of long dated options. I.e. long dated options become super-cheap when stability reigns, only to become super-expensive when instability reigns.

STABILITY BEGETS INSTABILITY

2008 was a classic financial crisis amplified by mortgage debt that could never be repaid. It was encouraged by governments because it created a 'wealth effect' which fed into the economy as a whole and translated into higher GDP. Soros in his book *The New Paradigm for Financial markets: The Credit Crisis of 2008 and What It Means* estimated 9 trillion in home equity refinancing in the US between 1996 and 2006¹.

The financial system nearly went down the gurgler as a result... Central banks stepped in and provided collateral, liquidity and zero interest rates.

It stabilised the system.

In reality, this stability is an illusion created by central banks. A homeless person is totally 'viable' with assets of \$1 and liabilities of a \$1,000,000,000 if interest rates are zero, fixed for 25 years and guaranteed by the central bank!

This stability has endured. So too have zero interest rates. Interesting correlation!

This enduring stability leads economic agents to become progressively more reckless and invest with more risk under the assumption of permanence. The more stability there has been, the more is assumed.

The longer the state of manufactured stability, the greater the ensuing instability.

Signs that the current system, whilst seeming stable, is becoming increasingly prone to instability?

- Implied volatility at decade low levels
- Rising interest rates
- Reduction of QE
- Emergence of inflation
- Reliance on human capital vis-à-vis real assets
- Reliance of cash flow multiples over net asset value
- Reliance on consumerism funded by increasing levels of debt
- Reliance of increased government spending funded by increasing levels of debt
- Reliance on corporate profits leveraged and funded by increasing levels of debt

Minsky went further in his Financial Instability Hypothesis and labelled three income-debt relations for economic units: hedge, speculative and Ponzi finance.

Hedge finance can be fulfilled from cash flows.

Speculative finance can manage to repay the interest but not the capital unless the asset price increases.

Ponzi finance needs the asset price to increase in order to even repay the interest.

He observed that the 'stability' cycle progresses through these stages of financing, the system becoming increasingly more fragile. Ponzi financing represents the last stage (normally).

Where are we now?

¹Soros, G. (2008) *The New Paradigm for Financial Markets: The Credit Crisis of 2008 and What it Means*, Hachette, UK: PublicAffairs™; p. xv

Most governments cannot repay even the interest payments out of cash flow because most run deficits. And that is with historically low interest rates which have been manufactured by themselves artificially! Japanese government debt is so large that at 4% interest rates ALL government receipts would go to repaying interest alone.

Europe ECB allows its member states to borrow at mostly negative rates. Most member states could not fund 4% interest rates out of cash flow.

Suffice to say they have reached the Ponzi financing stage. The system is not equilibrium seeking but instability amplifying.

In particular, over a protracted period of good times, capitalist economies tend to move from a financial structure dominated by hedge finance units to a structure in which there is large weight to units engaged in speculative and Ponzi finance. Furthermore, if an economy with a sizeable body of speculative financial units is in an inflationary state, and the authorities attempt to exorcise inflation by monetary constraint, then speculative units will become Ponzi units and the net worth of previously Ponzi units will quickly evaporate. Consequently, units with cash flow shortfalls will be forced to try to make position by selling out position. This is likely to lead to a collapse of asset values.

The Financial Instability Hypothesis, Hyman P. Minsky²

Fortunately the financial system has manufactured a way to hedge against this inevitable instability: invest in volatility.

This is understandably difficult when most investors insist on knowing a priori the name of the snowflake which sets off the avalanche BEFORE they feel it is prudent to invest in avalanche insurance.

Like experience, it is what portfolio managers will want just AFTER they need it.

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² Accessed at <http://www.levyinstitute.org/pubs/wp74.pdf>