36 South Views

AUG24

BY RICHARD "JERRY" HAWORTH

The credit casino

Everyone I know has a disquieting feeling that something is terribly wrong in society, but cannot put their finger on it.

Politicians believe all they need is more power and money to effect the changes they believe are necessary.

Activists believe they just need to destroy the current organisational structures to rebuild them with the value systems they hold dear.

The vast majority, the remainder, just buckle down, trying to negotiate an increasingly complex and burdensome system. They hope that reason might someday prevail and reserve their rantings for Friday night over a couple of beers at the pub.

Increasingly, politicians and activists are increasing their effect on society relative to the great unwashed, who look in horror at the impositions, both real and fictional, which they are expected to embrace.

Why has this trend come about?

My hypothesis is that the primary cause is the credit casino economy. It is the abundance of capital that is at the heart of all society's ills.

Pre-1987, politicians playing in this casino could extend credit to fund their changes only to the extent that the casino's guardians, in this case the bond vigilantes, agreed to.

Bankers could only extend credit with reference to their reserves, their prudence determined by their owners and the natural law of supply and demand of capital.

Companies, individuals and the rest of society were thus regulated by the amount of credit that they could safely assume.

But that all changed when central bankers distorted the "natural interest rate" in order to boost the economy when it merely looked like faltering.

Governments, in turn, availed themselves of this distorted rate to borrow imprudent amounts of money to finance their projects and, in turn, expanded their role in society massively. Bond vigilantes became an extinct species as shorting the bond market was a fool's errand.

Financiers leapt on the nearly free capital to leverage deals to buy all manner of assets at way above their natural value.

Homeowners, not willing to miss the gravy train, geared up on the only real way to leverage up and get ahead. That was by buying property and leveraging themselves to the hilt.

And so, the casino's credit line got so big and asset values so high, that it could not reverse course on interest rates and supply liquidity every time the markets jolted, without catastrophic damage (which we felt in 2008).

Central banks and governments have thus resolved to keep on extending the casino credit ad infinitum, which would work except for the niggling fact that history has proved it is indeed finite.

The niggling and disquieting feeling is that this time is again near at hand.

Here in the UK, the financing government's expanded role in a faltering economy is going to be met with higher taxes, especially for the highest paid and most asset-rich.

Do you think this will work?

The top tax bracket pays nearly 50% income tax and NIC. The 50% the hapless top earners receive, should they spend it, is further clipped by VAT of 20% and various duties mainly on the things they love, i.e., cigarettes, alcohol, driving, purchasing property, etc. Should they save it and then decide to spend it, they are further clipped by capital gains tax (which is slated to increase).

As a coup de grace, when they die, 40% of what is left is taken in inheritance tax.

Doesn't look like much wriggle room there, does it?

"Capital goes where it is welcome and stays where it is well treated ," once said Walter Wriston.

Capital is fleeing the UK to go where it is welcome and not shredded like a cow wandering foolishly into a piranha-infested Amazonian river.

Bravo Arthur Laffer and Steve Moore for writing "Soak the Rich, Lose the Rich"[1] and demonstrating Wriston's law in action. The gist:

> "With states facing nearly $100 billion in combined budget deficits this year, we're seeing more governors than ever proposing the Barack Obama solution to balancing the budget: Soak the rich."
>
> "Here's the problem for states that want to pry more money out of the wallets of rich people. It never works because people, investment capital, and businesses are mobile. They can leave tax-unfriendly states and move to tax-friendly states."

Without naturally residing capital, the government policies will backfire, leading to fewer tax receipts, not more. Bankers will have less to lend. Society at large will suffer yet another misguided policy.

This presumably will be met with more casino credit.

Once all internal avenues of credit have been exhausted, the currency becomes the final arbiter of whether this particular casino's credit is sound or not. e.g., Argentina.

When MOST countries adopt similar policies, the currencies might seem relatively stable, so the credit vigilante baton is passed to real assets like commodities whose value is not determined by credit. i.e., precious metals.

Real assets hold no country favouritism except where they happen to reside.

Real asset prices will rise, as will real asset inflation. A lower standard of living will be the result.

This inflation will be countered by real economy deflation as investors invest less and consumers consume less, leading to the erroneous assumption that "apparent" inflation is tamed.

Recent case in point...

"Our core customer, who contributes approximately 60% of our overall sales, comes predominantly from households earning less than $35,000 annually. Inflation has continued to negatively impact these households, with more than 60%

---

[1] "Soak the Rich, Lose the Rich", by Arthur Laffer and Stephen Moore in the Wall Street Journal. https://www.wsj.com/articles/SB124260067214828295

claiming they have had to sacrifice on purchasing basic necessities due to the higher cost of those items." wrote Dollar General CEO Todd Vasos.[2]

Is there a point where the credit casino bug hits the windshield? Sometimes… as in the Soviet Union in 1998…

Occasionally, as I imagine is the case here, the casino will carry on extending credit long past its sell-by date until we arrive at the point where, either the economy splutters and dies and no amount of government spending on mindless boondoggles will fix it, or the currency goes into freefall, thus amplifying the deleterious effects of inflation.

Then, as Pippa Malmgren once remarked, "We either get hyperinflation then war or war then hyperinflation." How close are we to the yellow squidge on the windshield?

Like playing a game of Jenga, piece by piece is removed from a once-sound structure. We know from playing the game that the situation is fragile and potentially unstable, but we also know how astonishingly long the structure can remain so.

Once the final piece is removed, the structure teeters and totters and goes from a state of low or no volatility to a state that was previously unconceivable.

Happy to be running a long volatility fund at this juncture.

[2] **The Transcript,** Dollar General's core customers appear to be in very bad shape by Todd Vasos
https://thetranscript.substack.com/p/09-03-2024-reaching-the-limit?utm_campaign=post&triedRedirect=true