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Intellectual and monetary bankruptcy

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Executive Summary

Why have we allowed Central Banks control over interest rates? We manage perfectly well letting free and unconstrained markets operate in the prices for commodities, goods and all types of services. Why should the interest rate on money be any different? Question what you read. Question everything. To ensure the sanctity and security of your savings and investments, the need to be curious and sceptical has never been more pressing.

Intelligence bulletins

Gold/silver ratio hits 2016 low

Silver priced in US dollars rallied over 13% from April 2nd to April 20th. That took the gold/silver ratio—the number of ounces of silver you can buy with an ounce of gold—to a 2016 low of 72.49. A declining gold/silver ratio usually indicates rising silver prices (rather than falling gold prices). Gold had its best first quarter in 30 years in the first quarter, rising by over 16% in US dollar terms. Gold priced in British pound is up 21.64% year-to-date at a recent price of £871.

Coachella goes cashless

California's trendy Coachella music and arts festival has embraced cashless transactions for festival goers. Organiser's encouraged vendors to accept Android Pay, Apple Pay, and Samsung pay at the point of sale. Gopi Sangah, the festival's director of digital strategy (it has one) said, 'Coachella has been rather militantly cash only for the long duration of its lifespan, but over the past three years we've been watching our sales and seeing credit card demand here and at other festivals really scaling heavily - this is a trend that couldn't be ignored and denied; it's the way consumers want to complete transactions onsite.'

Mitsubishi the new Volkswagen

Japan's Mitsubishi Motors has admitted it falsified fuel efficiency data for at least 600,000 vehicles sold in Japan. Company president Tetsuro Aikawa told a packed press conference in Tokyo that, 'The wrongdoing was intentional. It is clear the falsification was done to make the mileage look better. But why they would resort to fraud to do this is still unclear.' Mitsubishi's shares fell 11.18% following the apology.

Saudis take out $10 billion loan

How the mighty oil producers have fallen. As if the collapse of the Doha talks to reduce oil production and support prices wasn't bad enough, Saudi Arabia has been forced to hat in hand to global banks for a $10 billion loan, according to Bloomberg. The loan—reportedly made by a consortium of US, Japanese, European, and Chinese banks—will help plug a budget deficit expected to hit 17.8% of GDP this year. Falling oil revenues are blamed.

UK private home construction slumps

Britain has recorded the weakest growth in private housebuilding in three years, according to the Royal Institution of Chartered Surveyors. Financial data firm Markit produced a separate survey in March showing the same trend. Construction firms blame fears of Brexit for the slump in homebuilding activity.

Fingerprint money in Japan

You may be able to pay for your sushi and saki with a thumbprint if the Japanese Ministry Economy, Trade, and Industry has its way. The Ministry has identified tourist hotspots for a trial to begin in October where fingerprints and other biometric data will allow you to make transactions linked to your bank account. The trial aims to work out the bugs in the system before rolling it out fully in time for the 2020 Olympics.

Intellectual and monetary bankruptcy

Tim Price

"Don't just teach your children to read," said the American comedian and popular philosopher George Carlin.

"Teach them to question what they read. Teach them to question everything."

Some of the most dangerous things in life turn out to be those things you never question.

For most of my career in the City, which began 25 years ago, I never thought of questioning the role of central banks. I never thought to ask what their origins were. What their purpose was. Who owned them. They were just there, constantly asserting an influence on things, and always somewhere in the background, like the weather. There would be plenty of ritual around them: announcements of interest rate changes and those endless and normally over-hyped meetings of the FOMC – the Federal Reserve's Open Market Committee, the equivalent of the Bank of England's Monetary Policy Committee.

But for me that all changed with the eruption of the global financial crisis in 2007. As the credit markets first stuttered and then froze, the financial markets turned into a giant and complex "whodunit": just how did we get into this mess, and who was responsible?

Where central banks came from – and what they do

The Bank of England (BoE) was established in 1694, and its primary task was to raise money for the government of the day. That remains its core focus. Over time, it was granted weightier responsibility for the monetary management of the economy. In the 19th century it became the "lender of last resort", the guardian of the nation's banks during a liquidity crisis. Walter Bagehot's 1873 book Lombard Street was one of the first to explain the workings of the money markets and contained advice for the central bank in response to a banking panic. In the words of BoE Deputy Governor Paul Tucker:

"to avert panic, central banks should lend early and freely (i.e. without limit), to solvent firms, against good collateral, and at high rates."

The BoE was nationalised in 1946, and in 1997 it was given responsibility to set interest rates in order to meet the government's inflation target. In its own words, the BoE's mission is "to promote the good of the people of the United Kingdom by maintaining monetary and financial stability". But don't let the words fool you. Faced with a choice between supporting the banks or protecting the finances of individual citizens, the BoE has a duty to side with the banks.

But at least the BoE is notionally independent. The world's most important central bank, the US Federal Reserve ("the Fed"), is anything but.

G. Edward Griffin in his book The Creature from Jekyll Island explains how the US Federal Reserve was conceived.

On a cold November night in 1910, a handful of financiers boarded a private railway car in conditions of extreme secrecy at the New Jersey railway station. The passengers included the Republican “whip” in the Senate and a business associate of the banker J.P. Morgan; the assistant secretary of the US Treasury; the president of the National City Bank of New York, the most powerful bank of the time; a senior partner of J.P. Morgan and Company; the head of J.P. Morgan’s Bankers Trust Company; and a representative of the Rothschild banking dynasty in England and France. In other words, of the six passengers, five of them were representatives of private banks.

Those financiers would go on to meet in secret at a hideaway owned by J.P. Morgan and several of his business associates, where visitors would gather in the winter to hunt ducks or deer. The name of this remote retreat: Jekyll Island.

This group met in order to tackle five pressing issues:

1. How to reverse the growing influence of small commercial banking rivals and concentrate financial power among themselves.

2. How to allow the money supply to expand so that they could retake control of the industrial loan market.

3. How to consolidate the modest reserves of the country’s banks into one large reserve and standardise each bank’s loan-to-deposit ratios, thus protecting themselves from the possibility of bank runs.

4. How to shift any ultimate losses incurred by the banks onto the taxpayers instead.

5. How to convince the US government that the scheme was established to protect the public – as opposed to protecting the interests of a private banking cartel.

Perhaps most cynically of all, to address this fifth problem, the group decided to adopt the structure of a central bank and furthermore, ditch the use of the word *bank* altogether, in favour of a coinage that would evoke the image of the federal government instead. Three years later, after the passing of the resultant bill in Congress on 23 December 1913, the US Federal Reserve was born.

“The Federal Reserve System,” it today proudly tells us, “is the central bank of the United States. It was founded by Congress in 1913 to provide the nation with a safer, more flexible and more stable monetary and financial system. Over the years, its role in banking and the economy has expanded.”

Few could deny the latter point. Rather than maintain a narrow focus on managing the money supply, the Fed is now figuratively all over the shop, its fingerprints evident everywhere across the economy. Financial author and analyst James Grant:

“The Fed insists on saving us from ‘everyday low prices’ – they call it deflation. I submit that in a world of technological wonder, prices ought to be weakening: it costs less to buy things because it costs less to make them. This benign tendency the Fed resists at every turn. It wants the price level (as it defines it) to rise by two percent a year, plus or minus. In so doing, it creates redundant credit that finds its way into other things. These excess dollars do mischief. On Wall Street we call this mischief a bull market and we’re generally all in favour of it…

"The Fed, in substance if not in name, is [still] engaged in a massive experiment in price control. (They don't call it that.) But they fix the Fed funds rate, they manipulate the yield curve… they talk up the stock market. They have their fingers and their thumbs on the scale of finance. To change the metaphor, we all live to a degree in a valuation 'hall of mirrors'. Who knows what value is when the Fed fixes the determining interest rate at zero? So I said 'experiment in price control' but there is no real suspense about how price control turns out. It turns out, invariably, badly."

In the last issue of London Investment Alert, we examined the baleful history of price controls through the ages. Notwithstanding those "forty centuries of wage and price controls", the Fed, and our own Bank of England, along with the European Central Bank and the Bank of Japan, remain determined to control the most important price in the world – the price of money itself. But let's not overlook perhaps the most extraordinary aspect of central banking today, in that the US Federal Reserve, as G. Edward Griffin makes clear, is not an arm of the US government ***but a private banking cartel***. When you observe the Fed from this perspective, the quite extraordinary financial support offered to Wall Street after the failure of Lehman Brothers becomes a lot more understandable.

Imperious overreach

So we know where central banks came from: governments established them in order to secure finance for their inevitable overspending. And we know that in addition to raising money for governments, typically via the bond markets, central banks also fulfil the function of banking regulator and supervisor. But why have we allowed them control over interest rates too? We manage perfectly well letting free and unconstrained markets operate in the prices for commodities, goods and all types of services. Why should the interest rate on money be any different?

This question becomes more urgent when we consider just how far central banks have extended their efforts to control financial markets and the economy. Debt finance for government is one thing. But as James Grant points out in the quotation above, central banks now have their paws on everything.

The fund manager Paul Singer of Elliott Management in this video interview reveals his fears that the world's central banks, not least the Fed itself, have now done more than enough:

"I think there is one right thing to do right now. After five years of zero percent interest rates, after $3.5 trillion dollars (here) [of monetary stimulus], and several trillion sprinkled around the globe, this Fed chairman, the next Fed chairman or chairwoman, needs to say, and should say, 'We've done enough. It is up to the president, and Congress, to remove the impediments to growth and to provide catalysts for growth, and to help this country, and the developed world, grow.'"

To put it another way, since the dawn of the global financial crisis, politicians have been largely asleep at the wheel. A posse of unelected central bankers – many with links to Wall Street, notably Goldman Sachs – has stepped in to fill the policy vacuum, and is now taking the markets and all of us along with it into wholly uncharted territory. Quantitative easing (QE) and now negative interest rates (Nirp) are desperate policies made up on the hoof with no serious intellectual or, for that matter, even economic underpinning.

One of the leading advocates for stimulus, Martin Wolf of the Financial Times, published a column last week titled "Negative rates are not the fault of central banks". In which case, whose possible fault can they be? The central banks themselves ***set*** policy rates – the base rate here in the UK, and the Fed funds target rate in the US. And through the mechanism of QE, central banks are suppressing bond yields across the entire yield curve. If not the central banks, then who?

Wolf is not exactly sympathetic to those of us struggling to generate income and avoid risk:

"'Save the savers' is an understandable complaint by an asset manager or finance minister of a creditor nation. But this does not mean the objection makes sense. The world economy is suffering from a glut of savings relative to investment opportunities. The monetary authorities are helping to ensure that interest rates are consistent with this fact. Ultimately, market forces are determining what savers get. Alas, the market is saying that their savings are not worth much, at least at the margin."

I wasn't the only person to find this nonsense irritating beyond measure. FT reader "MarkGB" was quick to respond:
"There's nothing for it Mr Wolf, I am forced to admit that you are totally right.

"Negative interest rates are not the fault of central banks. Indeed it is churlish to assume that the people who stride the world stage with their optimal control panels should have the slightest degree of control over anything, optimal or otherwise. Clearly they haven't.

"As regards targeting inflation or creating employment it is equally clear that they haven't got the foggiest idea about any of that either. They are clueless and therefore blameless. So to hold them accountable for any of that is totally unreasonable of us.

"But the biggest injustice of all is to imagine that the people who spend their lives agonising over interest rates, people who rush for a microphone to talk about them every time Ray Dalio sneezes, people who write books about how they saved the world with interest rates and their love child QE… To suggest that those people are responsible for negative rates is just plain wrong… and highly negative by the way.

"No, NIRP is the fault of two well-known meddlers in human affairs – the tooth fairy and the invisible spaghetti monster. These are the villains who crept into Alan Greenspan's study one night in the early nineties and whispered in his ear… 'cheap money makes people borrow and spend… it makes things look good on the surface… the pols like that… Don't worry about paying it back, that's for another day…'

"Yes folks, the invisible spaghetti monster and the tooth fairy have trained a whole generation of Neo-Keynesian Astrologers with Friedman rising and their moon in Krugman… to believe that they are in control of everything but responsible for nothing.

"They are the real villains of the piece. Unfortunately they don't know the least thing about productivity, investment or wealth creation either – their PhD supervisor was Santa Claus and they think it's all down to him.

"So yes Mr Wolf you are right – negative interest rates are not the fault of Central Bankers.

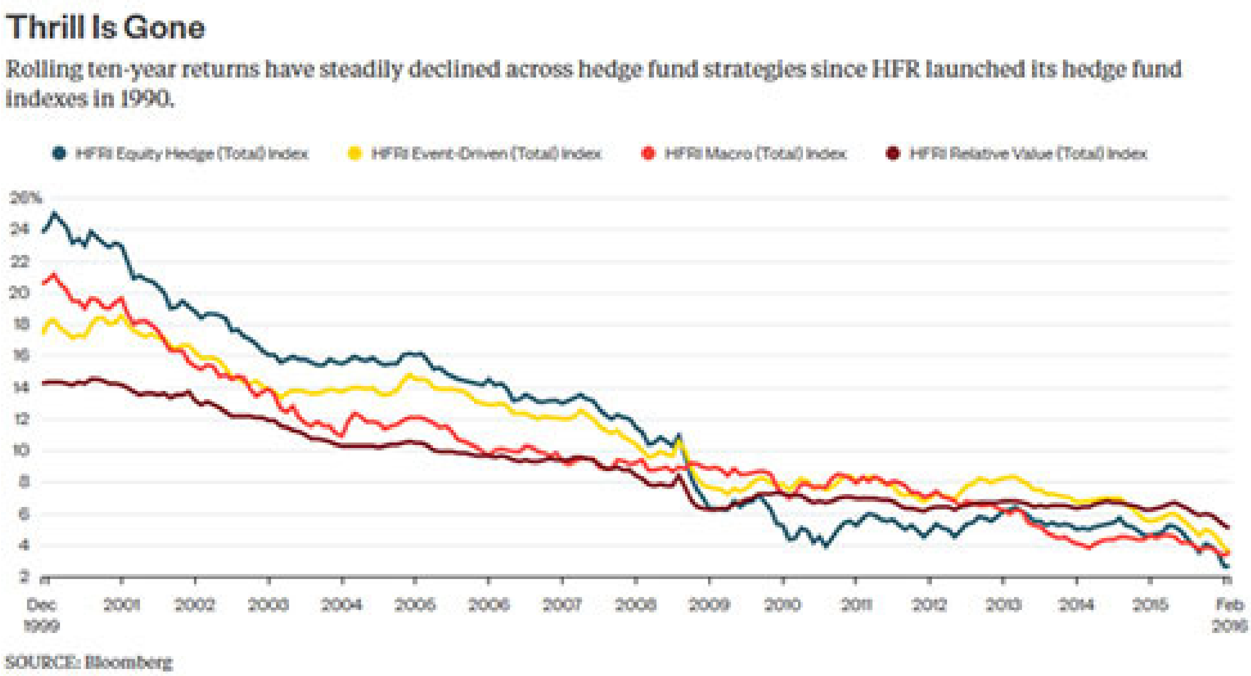
"To end on a slightly different note, let me say this:

"This is no way in a million years that a free market would EVER result in negative interest rates. They are a man-made contraption, a sign of intellectual as well as monetary bankruptcy, a product of groupthink and hubris. Rationalise as you will, justify as you like – markets don't DO negative interest rates – idiotic central planners and corruptible politicians create the conditions for them, then implement them, then deny responsibility for them."

So question what you read. Question everything. To ensure the sanctity and security of your savings and investments, the need to be curious and sceptical has never been more pressing.

Signals report

This week: HFR (Hedge Fund Research) Indices.



The concept of a hedge fund is relatively straightforward – albeit fraught with moral hazard given the current witch-hunt against anything that smells of tax avoidance. Credited with launching one of the first hedge funds, Alfred Winslow Jones was an American journalist and investor who realised that if he held a "long" portfolio of stocks he owned, he could offset (or "hedge") his market risk away by holding an offsetting "short" portfolio of stocks he had sold short. Imagine owning just one stock: Ford. Now imagine selling short another stock against it: General Motors. You now have a hedged portfolio (a long/short portfolio in the vernacular of the trade). It doesn't matter to you whether the stockmarket goes up or down. All that matters is the relative performance of Ford versus GM. If Ford stock outperforms GM you will make money. If GM outperforms Ford you will lose money. But the direction of the overall stockmarket is completely immaterial to you. It's as simple as that.

Over time Winslow Jones added some refinements to his fund. He used leverage (borrowed money) to magnify his returns (and losses). He also charged a performance fee to his clients. The hedge fund industry standard annual fee charge has traditionally been a 2% management fee plus a 20% share of performance. This model is admittedly under pressure now due to poor performance and competition in the industry.

There are a variety of index providers monitoring the hedge fund world. CSFB Tremont was one of the first. BarclayHedge – no relation to Barclays Bank – is another. Hedge Fund Research (HFR) is a third.

HFR maintain the HFRI index of hedge funds. As the chart above shows, while index returns were impressive in the index's early years (HFRI returned 18.3% annually during its first ten years from 1990 to 1999) subsequent returns have been disappointing, and they are getting worse. Rolling ten year returns across all the HFR major hedge fund strategies are starting to look dismally like those from cash.

The blue line shows the returns from equity strategies – like those of Winslow Jones' original fund. The yellow line shows the returns from "event driven" funds – typically hedge funds betting on the success, or failure, of mergers and acquisitions. The orange line shows the returns from "global macro" strategies – the sort of buccaneering, no-holds-barred trading that made George Soros a billionaire. And as the chart makes abundantly clear, the rolling ten year returns from every major hedge fund strategy have got progressively more dreadful.

Part of this can be accounted for by the fee burden – 2% management fees and a 20% share of any performance inevitably eats into investors' net returns. And part of the trend can be accounted for by the limited return available on cash, because few hedge funds remain always fully invested; many keep "dry powder" deposits to take advantage of future opportunities as and when they arise. I suspect the main reason for lousy performance is simply that the industry has got too big – there just aren't the opportunities available for all that hot money to exploit.

This is not to discredit all hedge funds or all strategies. I am a particular fan of what are called systematic trend-following funds, or commodity trading advisors (CTAs). These funds practise a form of momentum investing, and their longer term returns have been more than satisfactory, especially at times of market stress like 2008. To learn more about the world of CTA funds, visit Michael Covel's excellent site.

But as a general observation, hedge funds as an industry are failing their clients – much as their actively managed long-only peers are doing. These are difficult times for all investors, so it makes sense only to concentrate your search for specialist managers – if you elect to use them at all – on those who have a definable and proven edge.

Read this:

Returning to the theme of the central banks, Simon Wren-Lewis, Professor of Economic Policy at the Blavatnik School of Government at Oxford, asks just how many major mistakes central banks can continue to make and still retain their independence.
They failed to foresee the financial crisis, failed to manage both public and political expectations after interest rates reached their lower bound, and their next failure could be in tightening monetary policy prematurely. I'm not sure I agree with his last point, but I'm absolutely with him on the first two.

And read this:

Amazon's profits since 2012 amount to zero. Its stock has tripled, though. Apple has earned almost a quarter of a trillion dollars of profit since 2012. Its stock has barely moved. Whether you call it efficiency or rationality, markets clearly work in strange ways. In this excellent piece for The Motley Fool (remember them?) Morgan Housel points to the extreme difficulty of predicting future expectations in financial markets. He goes on to cite the ever-quotable value investor, Ben Graham:

"In the short run, the market is a voting machine. But in the long run, it is a weighing machine."

To which I add two observations, from the value manager Seth Klarman:

"In reality, no one knows what the market will do; trying to predict it is a waste of time, and investing based upon that prediction is a speculative undertaking" and "Once you adopt a value-investment strategy, any other investment behaviour starts to seem like gambling."

Until next time,

Tim Price.

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