

## 'Bring out your dead'

By Stewart Cowley

### Newton Global Fixed Income Strategy

*Overweight long-dated bonds in the West*

Today's announcement that the Bank of England is to create a £50bn facility to swap bonds on the books of UK banks for money market treasury bills looks like the financial equivalent of Mervyn King walking the streets of the City of London with a cart shouting "bring out your dead". Having read through the document, I'd hardly be rushing towards it unless I was absolutely desperate that it is. And there is a hint of desperation about it.

In the past few weeks we have shied away from joining the general clamour for attention as commentaries have become more hysterical (not in a funny way) and hyperbolic. Instead we have sat back and allowed the process of 'problem defining' and 'solution proposing' take its natural course. Having reached the end of part two of that process you have to wonder whether any of the solutions are actually solutions at all.

The general disapproval at hedge funds, those rapacious devils who use things like twenty times leverage to convert market beta into alpha, seems to have missed the mark over the past couple of years. Homeowners are at least twenty times leveraged and banks with an equity value of 4-5% of loans are themselves even more leveraged. You see the thing is that it's not so much that there is a particular group of people distorting the financial system through leverage, it's that EVERYBODY IS AT IT, at the same time, and that's what has to be stopped.

So swapping your bad loans for UK T-Bills (so that you can then presumably sell them into the market and lend the money to the economy and set the whole thing going again) sort of misses the point. All this would do is further increase the leverage in the system which is precisely what we don't need. If you think we are in a precarious state now imagine what the maths will look like if we pump ANOTHER £50bn into the UK economy in the form of secured and unsecured loans.

Whether it is the schemes in the US or the UK (or for that matter a similar, but more discreet, set of operations currently being used by the European Central Bank) the fact is that we don't need more borrowing, we need substantially less. But for economies that have become addicted to debt (when was the last time you heard anybody say they were 'saving up' for anything) our 'economic miracle' resembles nothing more than a pyramid selling scheme. Whether it is through interest-only mortgages or secured home equity release schemes, we seem to have conveniently forgotten that debts have a maturity date attached to them. There is going to be a day of reckoning for the 'debt generation' that will place them in a deeply uncomfortable place one day (i.e. living with their children when they are pensioners).

Set against this backdrop we also seem to have conveniently forgotten that the basic costs of life are rising; many of the news services have given up printing when oil hits a new all-time high because it happens virtually every day right now, and to some extent we are sleep-walking into a really big problem. We are so preoccupied with making sure a group of bankers don't get a lesson in how risk and reward works that the things that will finally tip our economies over the edge are getting much less attention than they should.

I am heartened to hear that there is a growing appreciation that our relationship with inflation has changed a view that I have held for a couple of years. No longer, because of de-unionisation, do we have formulaic pay awards to compensate us as the basic costs of living rise. Instead, if the cost of feeding yourself and your family rises, the cost of heat and light increases, the cost of your mobility rises and the cost of putting a roof over your head increases, then something has to give somewhere else in your budget. The foreign holiday goes (as someone who took a wife and three children to Paris recently I can tell you, as a Brit, it is now eye-wateringly expensive), the trips to the restaurants go, the high-end clothes and in general the edges of life just disappear which is when the economy really starts to turn downwards in a very real sense (especially when 70% of GDP is based on consumerism these days).

In many respects you can collapse the money argument and the cost of living argument into a version of the 'Quantity of Money Theory' approach to the economy which is governed by the equation;

$$M.V = P.Q$$

Where M = amount of (borrowed) money, V = velocity or speed money swirls around the economy, P = Prices (inflation) and Q is as measure of GDP.

If you are Mervyn King or Ben Bernanke then what you are worried about is the money part of the argument, that you don't necessarily want M to increase (the amount of money in the economy) but unfortunately V has fallen because banks won't lend to each other. So all that the 'bring out your dead' schemes are really doing is keeping V up so that P.Q doesn't collapse (i.e. create an economic depression with deflation). That would be bad.

You can tackle the Cost of Living part of the argument by further breaking this down notionally into your 'core' needs and your 'discretionary' needs;

$$M.V = (P_c.Q_c) + (P_d.Q_d)$$

So let's imagine for a moment that Western central bankers manage to stabilise M and V, but the problem now becomes that your core prices (food and fuel etc) are rising and fast. You could reduce the quantity of your core needs you consume ( $Q_c$  – requiring a level of austerity we are not accustomed to) and stabilise the relationship or you can fiddle with the discretionary elements of your life ( $P_d.Q_d$ ). In other words you can reduce the amount of discretionary spend in your budget and do it at a lower price level which adds up to a deflationary recession on the High Street and opens the way for interest rate cuts.

This is all a rather long way of saying that although actions of the Bank of England and the US Federal Reserve are a welcome stabilising influence they are not a solution *per se*. Instead, as unemployment rises and the cost of living increases because of commodity price rises we should look out for long-range deflationary forces coming through in our economies which will require/allow further interest rate reductions and bond yields to fall further.

FOR PROFESSIONAL INVESTORS ONLY

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