ZANACORP

Investment Insight

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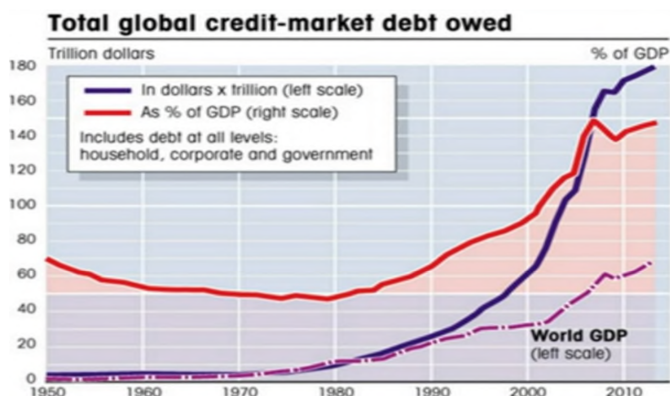
2018 appears destined to close out as a financial non-event for investors with most markets barely moving. Mid year double digit returns have evaporated, overcome by (excl. US) sluggish global GDP growth. Mounting international trade tensions, escalating US interest rates, low wages growth and the Royal Commission enquiry into banking in Australia have skittled the once confident investment plans of both countries and consumers. As each year passes and millions of boomers clock off from the workforce, their financial destiny seems increasingly more difficult to predict. Built on unprecedented levels of borrowings, bailouts and stimulus, the post GFC boom is slowly running out of puff.

Debt Does Not Matter Any More… Well, At Least For Now

For many years we have expressed concerns that the world's economy is underpinned by both excessive government and household debt. We have discussed quantitative easing, zero interest rates, unconventional economics, all booms end, etc, etc. Yet the sky has not fallen in, nor the world fallen apart. So what is the problem one may ask? Take a look at the graphic below and focus on the thick blue line and its trajectory.



You are looking at history in the making. It is a **debt bubble**, a term we use sparingly. Despite China's huge contribution to growth, debt and GDP have decoupled for so long and so widely, nations and citizens no longer understand living within their means. Governments deliver services relying on debt and households increasingly consume, also on debt, blinded by illusory house prices. Who saves anymore? We have been taught to borrow to make money, rather than work, because rising asset prices do the heavy lifting. Our world is so addicted to debt, its orderly function is now dependant on it to keep prices high. **The more we borrow, the greater will be the cost, when the day of reckoning arrives.** That is the problem.

Bad Medicine

Until the 19th century, most physicians practised "blood-letting" including the use of leeches, as a treatment for many diseases. More often than not, this trusted and widely used practice caused more harm than good. Medicine had not yet developed any viable alternative. Today, painless antibiotics shots cure many of the deadly diseases of yesteryear.

In modern economics, a "reverse blood-letting" philosophy has been adopted. Put simply, we know how to cure the world's distorted financial imbalances. However, the currently unacceptable prospect of western austerity and a decline in living standards, drives us to dream up confounded and plainly ill-conceived economic constructs, to delay the inevitable.

Commodity Based Money

Awareness of today's warped and terminally fated system of money flows has been somehow lost as a result of a denial to acknowledge the merit of the systems it evolved from. Systems with embedded fiscal constraints.

Up to the 18th century, international and domestic money flows were based on how many units of a currency equated to a unit of precious metals like silver or gold. All currency, coins and notes merely reflected the equivalent weight of a precious metal. Unsurprisingly in the centuries of British rule, a British Pound Note (£1) was the equivalent of 1 pound of silver (or 240 silver pennies). This is the origin of the Pound Sterling.

Exploration, piracy, war and colonisation were motivated more by the hunt for precious metals than the now commonly accepted myth of religious fervour. Money meant power. By 1834, the global measure of currency became gold. Its higher value and relative scarcity proved it a more suitable commodity for growing global trade. Known as the **GOLD STANDARD**, it remained intact until the outbreak of the Great War in 1914.

The classical gold standard currency rules reflected an orderly sophisticated and intricate supply /demand model, which ensured each and every country traded within its financial means. Prices and spending within each country by government, business and people had to be backed by a (fractional) reserve of physical gold. Government spending was kept in check by the need to hold gold reserves. If there was no capacity to increase gold holdings, government spending was cut or taxes were increased, resulting in price adjustment inflation or deflation and shifts in imports/exports. This mechanism soundly managed all booms and busts for hundreds of years, quarantining their duration, but not their severity.

Post WW1, the UK attempted to reclaim its pre-war global dominance but was left hopelessly bankrupt. In 1931 Britain abandoned the gold standard, with many other countries, in order to allow governments to mindlessly print money in response to The Great Depression. Hyper-inflation and the resultant social & economic mayhem in no small way led to World War 2.

The British Empire was dismantled after WW2. In its place rose a new world power, the United States. 18 days after D-Day in 1944, an economic summit held at Bretton Woods, New Hampshire reinstalled the global gold standard and **the US dollar became the new global reserve currency.**

One US dollar represented 1/35th of an ounce of gold to which the Franc, Pound, Mark etc. represented different relative weights of gold. Close inspection of this Australian Treasury 1000 Pound note reveals the Commonwealth "Promises to Pay the Bearer in Gold Coin on Demand".

Order was restored to global trade, accountability to governments and economic incentives to war ravaged nations that worked hard. Refinements to the gold standard rules permitted currency revaluations and devaluations allowing countries to fine-tune their economic settings. The treasured 1950's at last promised prosperity and stability, until…..

The peacetime bonus that drove US economic dominance waned as the Cold War and expanding Communist threat, firstly in Korea, then Vietnam became more costly to repel. The space race against the USSR raised the stakes and plummeted the US into a debt spiral. Like Britain before it, confronted by an economy that had lost its wealth, **the humbled US repudiated its obligations under the gold standard in 1971**, under threat from the

French to reclaim most of the gold in Fort Knox, representing their reserves. **These events were only 47 short years ago**. But few recall them.

Fortuitously for the US, the world still supported their claim as the global reserve currency. Thus, so long as the Greenback remained in demand, successive US governments have found foreign nations willing to underwrite their deficits, with seemingly no adverse consequences. As most international trade was and indeed is still today, denominated in US dollars, the US could uniquely turn on the currency printing press and avoid inflation and live beyond its means, generation after generation. Like the Romans.

Not to be outdone, the fall of the Berlin wall in 1989 led to the European Frankenstein (otherwise known as the European Union) and the creation of its own brand new currency, the Euro, backed by nothing but a multinational agreement. This convenient truth permits ECB Chairman Mario Draghi to promise participant nations "we will do whatever it takes" to save them. Well why not, just add zeros on a computer and it is done!

In two decades, centuries of Western fiscal responsibility, based on commodity backed currencies was undone. Bureaucrats decided they could run things better than a prescriptive model. Meddling with economic principles, bankers promised society subsidised education, healthcare and welfare. Decades later, the cost of the new age of entitlement and social justice has ballooned. **US debt is currently US$21trillion**. Unfunded future obligations to an ageing population, suggests the debt is unlikely to be repaid. The US dollar says "In God We Trust". Ironically, God may end up with the bill!

Fiat Currency

Fiat currency means a currency with no intrinsic value, established as money by government regulation. Its value is based exclusively on counter parties agreeing and engaging in its trade in exchange for goods and services, resting entirely on trust in the issuer's financial good standing.

Presently the US and EU bankers can create currency without limit. There is no silver, no gold and no value guarantee to the holders of notes or coins, only trust in US/EU government to make good. Assume this can last another 4-6 years and then confidence (or trust) is called into question. Then what?

As it happens, we have a current country with 32 million inhabitants who can tell us it may not end well. Ask a Venezuelan. It may be hard to believe that in the 21st century, a significant country rich in oil can have a hyperinflation rate of 83,000%. Controlling more oil than Saudi Arabia, food, power, even toilet paper, are in extreme undersupply with millions fleeing the country. **This is fiat money where TRUST is lost**. The economies of Turkey, Pakistan and Argentina appear the next to fall with much human suffering. Do you think the citizens were told this was coming? We suspect not.

A problem with fiat currency is that it develops unhealthy social expectations, **collective corruption**. Knowing that public money is effectively limitless means we, individually and collectively believe everything can be paid for and the wants of all accommodated. It is in no one's interest to put an end to this bliss, after all, who wants to unnecessarily endure financial pain, or appear unsympathetic to the less fortunate? Democracy affords these socially altruistic goals, except **most individuals prefer others bear the cost**.

Why No Inflation?

Purists would argue the post GFC global explosion of fiat currency should have resulted in rampant inflation across the globe. That has not happened. Most common measures of inflation (CPI) capture the price movement in a basket of goods and services. The combination of cheap Chinese goods, the price destructive nature of goods available on the internet and stubbornly low wages growth across the planet, has uniquely suppressed CPI price rises. However, inflation has conspicuously presented itself almost everywhere in extreme credit driven **ASSET PRICE INFLATION.**

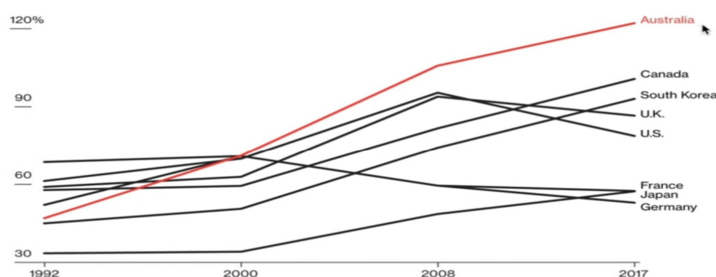
The post GFC global economic response of cheap and easy money has failed to lift real incomes but substantially increased both asset values and debt, inducing wealth effect consumption and what appears to be economic recovery. In this unnatural world of funny money, we believe neither is sustainable. **The prices of shares and property do rise, until the day they don't**.

Smart as we are, we haven't learned much about people. **Systemic problems require systemic solutions.** Commodity based currencies delivered them, painful as they were, and taught us lessons. 21st century economic alchemy of QE and negative interest rates reduced the burden of debt rather than the amount of debt. It avoids the pain and the problem. The world's governments now only have 2 real alternatives, hyper-inflation to dilute the cost of their debt, or a debt jubilee to cancel it. Think 2023-2025.

And The Winner Is….. Australia

Until now, our paper has primarily discussed governments recklessly issuing money, credit and IOUs. Because they can. **Governments don't die or get sick, or lose their jobs. They can raise taxes or cut spending at will.** Now let's consider householders, ordinary people working for the man and paying taxes, with the yoke of life's human frailties, fatigue and aspirations.

Forget bailouts, QE and all the money tricks used overseas. Australia sailed through the GFC unscathed, thanks to our Asian neighbours who needed our red earth. By golly, RBA interest rates even fell from 7% in September 2008 to 3% by April 2009. The GFC was a borrowers' bonanza with banks willingly lending money, often lots of it, to anyone who could fog a mirror. No wonder prices went up. **For savers, cash became trash.** Much of the liquidity of European banks found its way to Australian in **over $1tr of foreign debt**, funding our banking system and our appetite for home loans.



The graph above is remarkable by the GFC inflection point on or after 2008. US, UK, German and French households have lowered debt whilst other **countries, mostly those that supply Asia**, **continued to borrow and spend** as their GFC experience was muted. Including China, these are the countries now most vulnerable to shock as their **households are overleveraged.**

Contributing to a perfect storm for Australia, rising US interest rates, slowing Chinese growth and a softening housing market were capped off by the findings of the Royal Commission (RC) into banking. It seems the Commission told us what we didn't want to hear—in cahoots with banks (who profit from lending), we have borrowed too much, lied on loan applications and taken over 40% as fixed term interest only loans. This unholy trinity of behaviours mirrors that of the pre GFC US. Excluding property investor debt, **householders in Australia owe a staggering $2 trillion and rising.**

The post RC response of banks has been to tighten lending and slow down credit expansion. While this may sound good, indeed overdue, the price we are just starting to pay is **falling house prices**, with more likely. Bank shares are dropping, new car sales collapsing, retail sales slowing and confidence eroding. These responses should not surprise readers, we have long anticipated them. What we are seeing is what happens when we **return to responsible lending.** Erroneously called a credit crunch, what is yet to be seen, is if our collective government brains trust is able to orchestrate an orderly unwinding of debt or something other than that. Watch this space.

What About The Here And Now?

Presently, we are relatively comfortable with most market risk pricing, based on current conditions. We are however, mindful of its acute fragility. Addressing increasing risk, rest assured all Zanacorp client portfolios are reviewed and where necessary, asset allocations adjusted. If we have not already, we will contact you. **Your financial well being is our concern**.

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