

## Some of the investment & economic risks that lie ahead.

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Over the last two days, I have read 2 articles which provide some very important insights on what is ahead for the global financial system:

- John Mauldin Newsletter  
[http://d21uq3hx4esec9.cloudfront.net/uploads/pdf/140426\\_TFTF2.pdf](http://d21uq3hx4esec9.cloudfront.net/uploads/pdf/140426_TFTF2.pdf)
- Andy Xie article <http://www.thecorner.eu/world-economy/long-goodbye/36962/>

Summaries have been circulated to clients but here are of some of the most important points (just to give you a flavour):

In the John Mauldin newsletter, John shares some key parts of an interview with Bill White, ex-chief economist for the Bank of International Settlements - "the oversight body for the world's central banks and banking system."

- "The honest truth is no one has ever seen anything like this. *Not even during the Great Depression in the Thirties has monetary policy been this loose.* And if you look at the details of what these central banks are doing, it's all very experimental."
- Do you see outright bubbles in financial markets? "Yes, I do."
- "*we are back in a world where the banks get all the profits, while the government socializes all the losses.* Then it just gets worse and worse. So, in terms of curbing the financial system, my own sense is that all of the stuff that has been done until now, **while very useful, Basel III and all that, is not going to be sufficient to deal with the moral hazard problem. I would have liked to see a return to limited banking, a return to private ownership, a return to people going to prison when they do bad things.** Moral hazard is a real issue."
- "*I have no difficulty in seeing this thing tipping overnight into hyperinflation. If you go back into history, a lot of hyperinflations started with deflation.*"

In Andy Xie's article:-

- "**The global financial system has experienced one bubble after another because major central banks have kept monetary policy loose.** Prolonged loose monetary policy has made the financial system extraordinary large relative to the real economy. This change forces central banks to respond to negative shocks, like the bursting of a bubble, from the financial system. Such responses make the financial system even bigger. This vicious cycle explains why speculation has become such a powerful force."
- "*Real interest rates will remain negative until another crisis, like high inflation or hyperinflation or political crisis, force the hand.*"
- "Gold is the safe asset in today's environment. As paper currencies lose credibility, the demand for gold will surge."
- "Bubble formation has become central to supporting a bloated financial system. A large and bubbly financial system is unstable. Its periodic collapse brings down the economy, which triggers more monetary stimulus. Hence, constant monetary stimulus and an ever-expanding and bubbly financial system have formed a vicious cycle."
- "There are two things unusual about how a bubble deflates today.
  - First, they deflate slowly. The multi-year deflation of a liquid asset is not often

seen in history.

- Second, when a bubble deflates, a new one tends to arise somewhere else.

So what are some key takeouts (Bruce Baker comments):-

- First, my impression is that there is not too much disagreement between Andy Xie's position and that of Bill White. Both are describing different aspects of the same problem.
- I think that Andy Xie is right in that the world's major economies are likely to keep real interest rates negative for years to come - for no other reason than "financial repression" so as to enable those major economies to pay down their government debt.
- Along the lines of Andy Xie's thinking, given that central banks are likely to maintain very accommodative monetary policy for years to come (while they can), even though many asset prices are in bubble territory, these bubbles may not pop for years ..... and even when they pop, they might deflate more gradually than bubbles normally would. (The exception to this is if the bubble is burst by a financial crisis of course.)
- Andy Xie is also clearly saying - EXPECT MORE BUBBLES. And that seems logical and likely.
- Both Bill & Andy clearly see the global economy as being fairly sick - as in the global economy is not functioning like it optimally should. Far from it.
- I think, the message is also clear - that another global financial crisis seems like a very real probability - though it may be some years away just yet. I think a future financial crisis is more likely than not (though probably years away), simply because of the argument used by Andy Xie that "*Real interest rates will remain negative until another crisis, like high inflation or hyperinflation or political crisis, force the hand.*"
- Finally, heed the warning of Bill White - *hyperinflation could well be in our future.* Obviously Andy Xie sees this possibility as well.

Let me conclude by including the leading quote in John Mauldin's newsletter:

- "There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved." – Ludwig von Mises

This is obviously a very applicable quote for these times.

Appendix.

The last time that the USA had an extended period of negative real cash rates was the 1970s.

