The Adam Smith Lecture, Pembroke College, Cambridge

‘The Abolition of Risk- Economics on Speed’

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The Abolition of Risk- Economics on Speed

- **Speed Definition**

  the rate at which someone, or something, moves, or operates, or is able to move or operate.

- **Speed Definition**

  Speed is amphetamine, an artificial stimulating drug that triggers the brain's reward system giving the user feelings of pleasure.

- **Economics on Speed -Walbrook Definition**

  The deliberate action of policy makers to artificially stimulate an economy through monetary, fiscal and regulatory means.

Key Messages

- Prosperity is fragile built on fiscal and monetary nitro glycerine.
- Liberal free market economy under sustained attack in Western Europe.
- Monetary policy at a 300 year extreme- no historical precedent.
- Fiscal deficits have mushroomed with little left in reserve.
- Regulation is in over-drive.
- The US has largely escaped. The major risks lies with the UK and Eurozone (for different reasons) and Emerging markets.

- Solutions - a) gradual monetary normalisation.
  b) fiscal reform.
  c) leadership and long term solutions, not short term crisis management.

10 years after Lehman- imbalances extreme

- Government policy is unprecedented and growing in almost all areas of civil society:

- Monetary
- Fiscal
- Regulatory

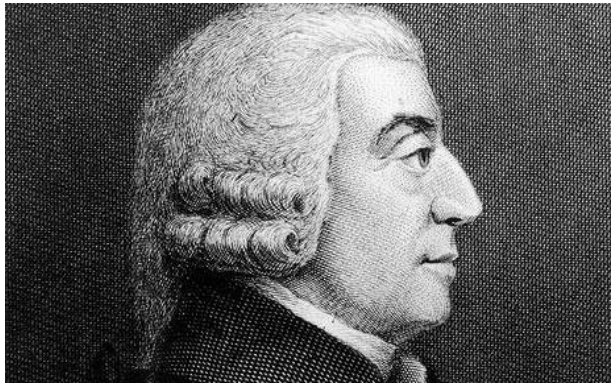
- Kicking the can down the road may have been necessary, to avert a 1930's style collapse, but the longer term consequences risk disaster for much of the West.
- Increasing micro management, monetary activism and given fiscal and political pressures the attempt to smooth the cycle risks arbitrary government moving very far from the ideals of liberal free-market solutions.
- The West, ex the US, is on a treadmill which risks creating an even bigger bubble.

How it was the year my grandfather was born

'Until August 1914 a sensible, law-abiding Englishman could pass through life ***and hardly notice the existence of the state****, beyond the post office and the policeman.*

Source: APJ Taylor ' Effects and Origins of the Great War'

And what did Adam Smith say?



*'It is the highest impertinence and presumption… in kings and ministers, to pretend to watch over the economy of private people, and to restrain their expense... **They are themselves always, and without any exception, the greatest spendthrifts in the society**. Let them look well after their own expense, and they may safely trust private people with theirs. If their own extravagance does not ruin the state, that of their subjects never will.'*

The Wealth Of Nations, Book II, Chapter III, p.346, para. 36

The Great Moderation?

- Happy days? 64 quarters of unbroken growth.

- Gordon Brown even claimed that *modern economics had abolished stop-go*. David Cameron said he *would share the fruits of prosperity….*

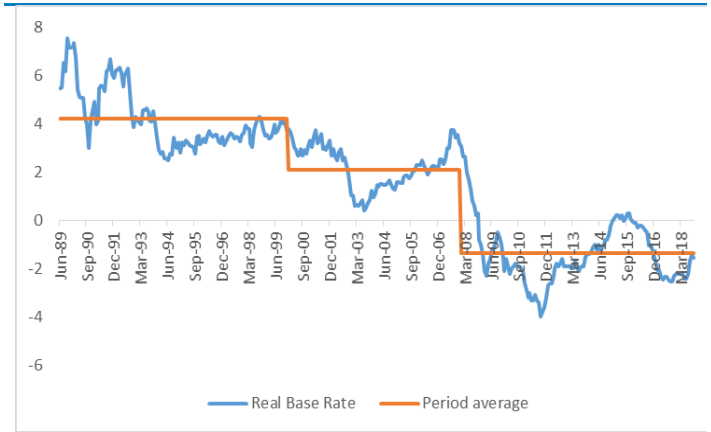
- Rather, we would argue that the appearance of sustainable consistent growth was less a function of prudential macro-economic management but more a persistent, if silent, leveraging of the economy as governments, consumers, corporates and financial institutions all increased their risk appetite and debt levels, thus 'bringing forward' consumption.

What caused the global leverage?

- The collapse in the global price of money, sending a signal to banks, corporates and consumers.
- Political pressure to relax bank lending criteria.
- The Euro conversion trade lead to bubbles forming amongst the peripheral Eurozone economies.
- In some countries a ramp up in public spending based on a false assumption of ever growing tax receipts.

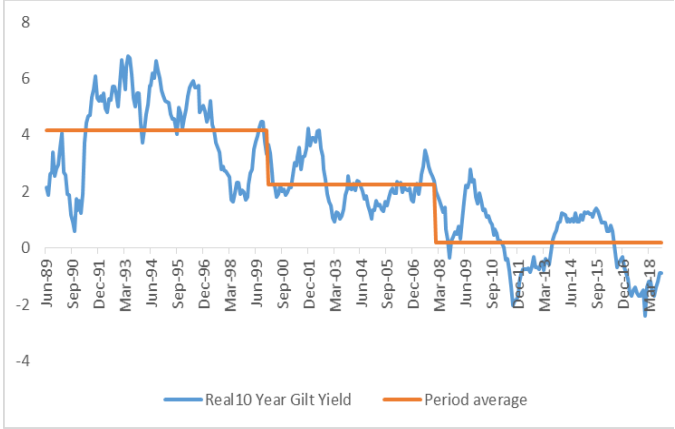
The Great Moderation – real price of money halves, banks binge

UK Real Base Rate and period averages (1989-2000, 2000-07,07 to current) %



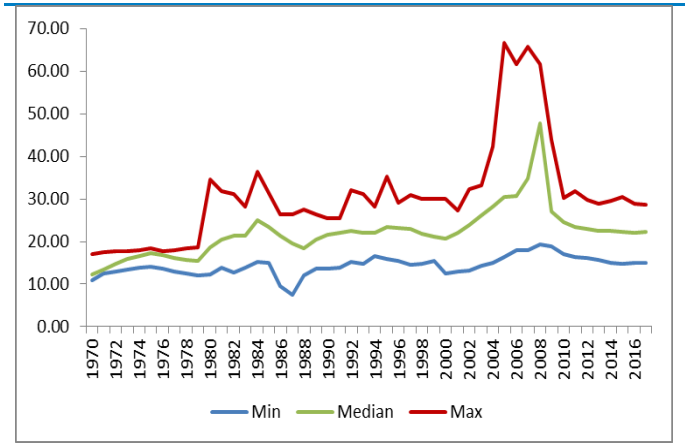
Source Walbrook Economics

UK Real 10 year gilt yield and period averages (1989-2000, 2000-07,07 to current) %



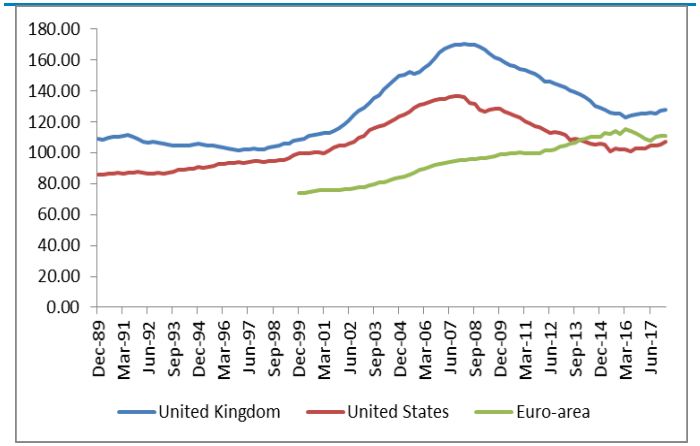
Source Walbrook Economics

UK Banking leverage relative to book value x



Source Bank of England

Household Debt to income – 1989 to current & income



Source Bank of England, ECB, Fed

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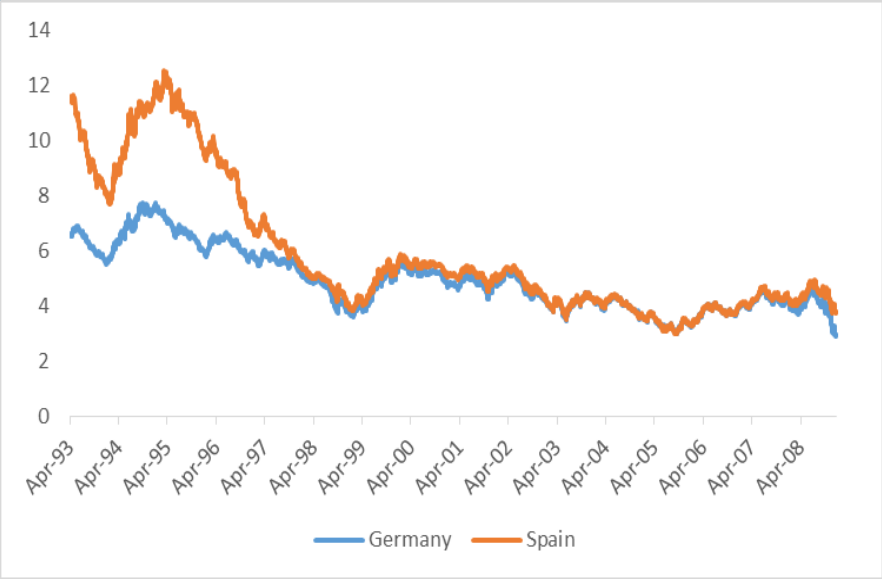
Euro convergence trade leads to asset bubble

Euro convergence trade- 10 year sovereign bonds % yield - Germany and Spain 1993-2008



Source Trading Economics

The *Great Moderation* big leverage

Change in debt levels to GDP by country - 2008 on 2000 %

	Gov'nment	Non Financial	Household	Total
Ireland	7	72	41	120
Japan	29	-13	-12	4
Belgium	-20	36	10	26
Portugal	22	37	30	89
Netherlands	2	-17	27	12
Sweden	-14	43	21	50
Spain	-19	54	37	72
UK	14	22	31	67
US	21	9	26	56
Greece	-1	19	38	56
Italy	-5	21	16	32
France	-5	11	15	21
Switzerland	-9	-1	1	-9
All	2	4	9	15
Australia	-15	8	38	31
Germany	1	-2	-7	-8

Source McKinsey

Pop

- Ultimately it went pop – Government action encouraged inappropriate lending.
- US sub-prime blamed but that was really the symptom not the cause.

The response

Unprecedented…..

…..in terms of global co-ordination, monetary and fiscal….

Monetary- the primary tool

Central Banks – send a signal

- QE – globally $21.3tn over last decade – around 25% Global GDP.
- UK £435bn, or around 22% GDP. It will probably never be unwound.
- Sovereign bond yields- especially in UK and Eurozone increasingly do not reflect market forces (in our view) - impacted by intra-central bank buying, QE, regulation on banking liquidity and pension fund holdings.
- No rational investor would buy UK 10 year debt yielding 1.42% when CPI was 2.2% with all the political and economic risk entailed. Even less probable is German 10 years at 38bp and Swiss negative 6bp.
- This is critical because all debt, from humble mortgages, to corporate debt, is priced off sovereigns.
- Manipulate the price of money (away from the free market price) and you manipulate Government, consumer and corporate behaviour.

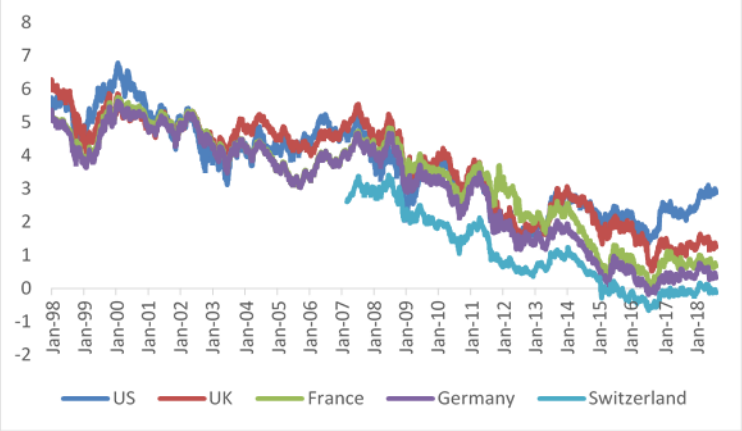
The price of money collapses

Developed Market Bond Yields %

Country	3 month swap	Bond Market (yields) 2 yr	5 yr	10 yr	30 yr
Australia	2.96	1.97	2.16	2.62	
Austria	-0.36	-0.63	-0.10	0.58	1.38
Belgium	-0.36	-0.55	0.02	0.77	1.71
Canada	1.17	2.31	2.40	2.46	2.50
Denmark	-0.30	-0.62	-0.16	0.32	
Finland	-0.36	-0.58	-0.07	0.64	1.22
France	-0.36	-0.44	0.09	0.74	1.62
Germany	-0.36	-0.63	-0.20	0.38	1.02
Greece	-0.36			4.19	
Hong Kong	2.11	2.02	2.24	2.31	
Ireland	-0.36		-0.05	0.94	
Italy	-0.36	1.03	2.44	3.41	3.95
Japan	0.07	-0.13	-0.09	0.12	0.86
Netherlands	-0.36	-0.69	-0.17	0.51	1.05
Norway	1.14			1.91	
Portugal	-0.36	-0.15	0.68	1.87	
Singapore	1.64	2.03	2.27	2.49	2.92
Spain	-0.36	-0.13	0.54	1.55	2.67
Sweden	-0.44	-0.45	0.06	0.59	
Switzerland	-0.74	-0.81	-0.49	-0.06	0.47
UK	0.81	0.71	1.00	1.42	1.84
US	2.53	2.86	2.97	3.14	3.38

Source Trading Economics

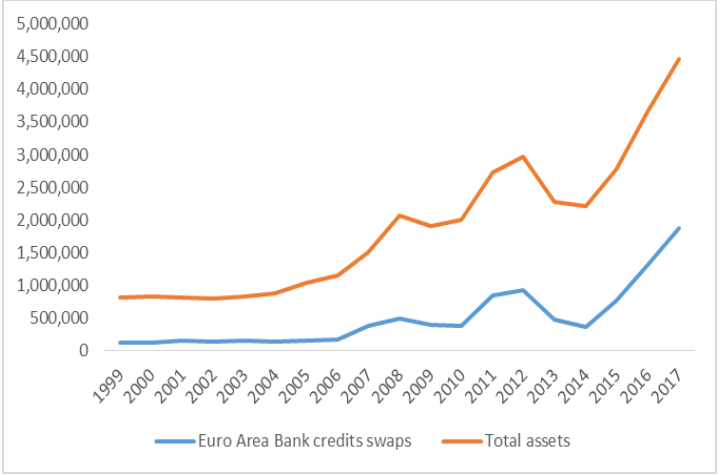
Key Global 10 year Sovereign bonds since financial crisis %



Source Trading Economics

Moreover….

ECB Balance Sheet – Euro Area Brank credit swaps and total assets €m



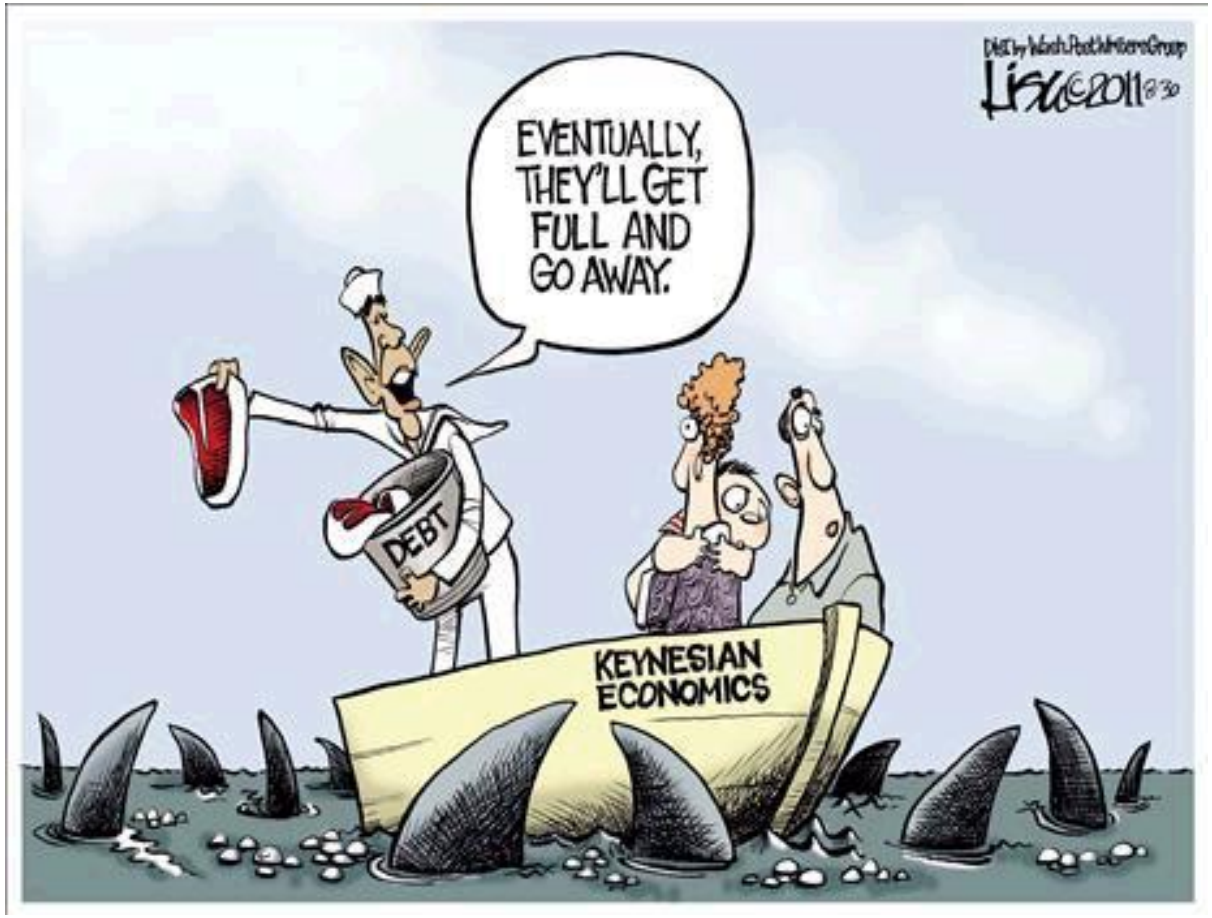
Source ECB

- Central Banks flood the system with liquidity.
- ECB balance sheet increases from €800bn to €4.4tn in a decade on a formal capital base of under £10bn (ultimately backed by national Governments).
- Asset swaps – For example ECB take on Italian Banking debt (sub-prime maybe?)
- Creates illusion of unlimited fire power and to an extent it is.
- Implications are profound- distorts asset allocation and investment decisions with long term consequences for productivity and growth.

Consequences

- Boosts asset prices and helps stem banking write-offs.
- Transfers wealth from private to public sector.
- Transfers wealth from savers to asset holders- real estate, equities.
- Distorts asset allocation and increases political/ central bank uncertainty into the decision making process.
- Arguably reduces productivity via ‘crowding out’, misallocation of capital.
- Arguably is a factor behind the end of ‘consensus’ politics.

The Fiscal Response- the secondary response



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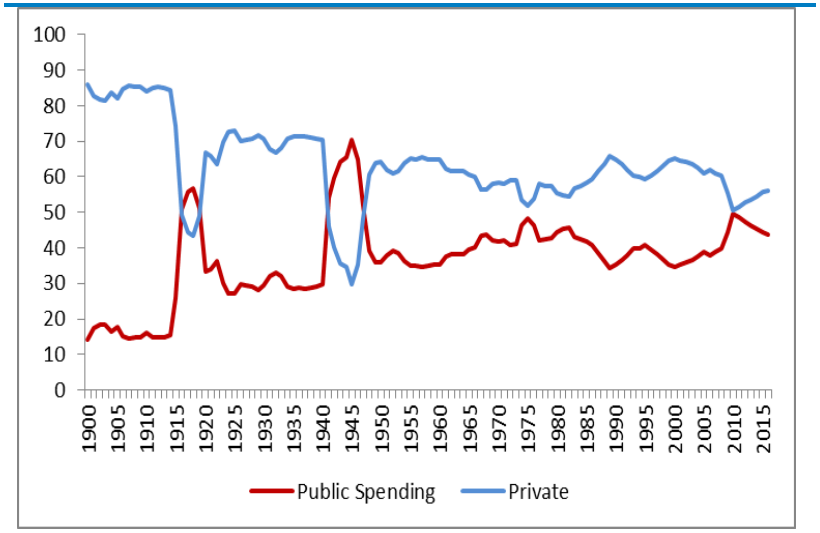
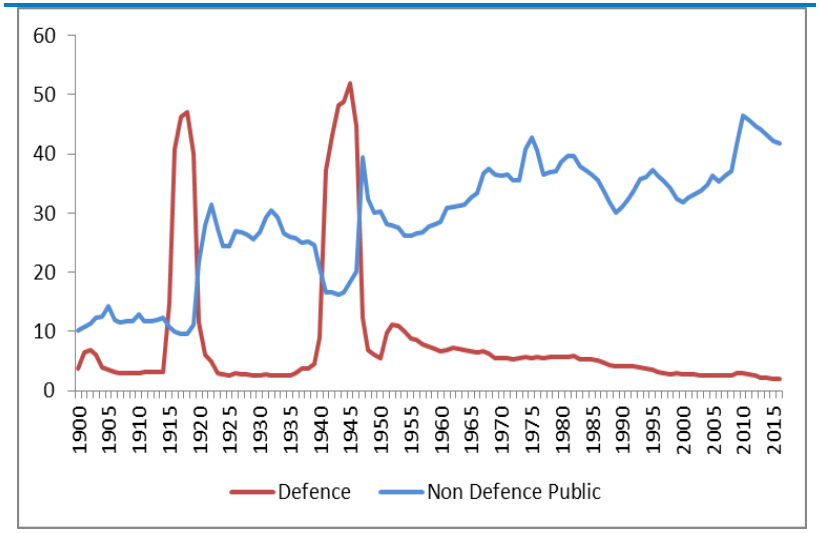
120 years of the State- Smith would not have approved

120 years of public spending % GDP



Source ONS

120 years of the welfare state % GDP



Source ONS

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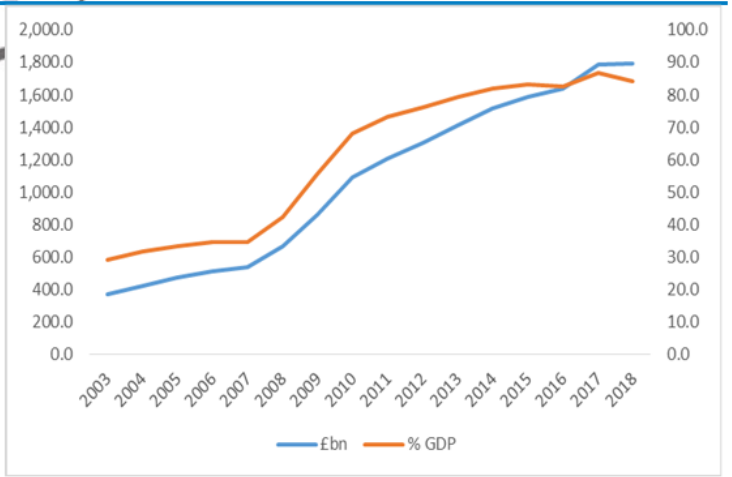
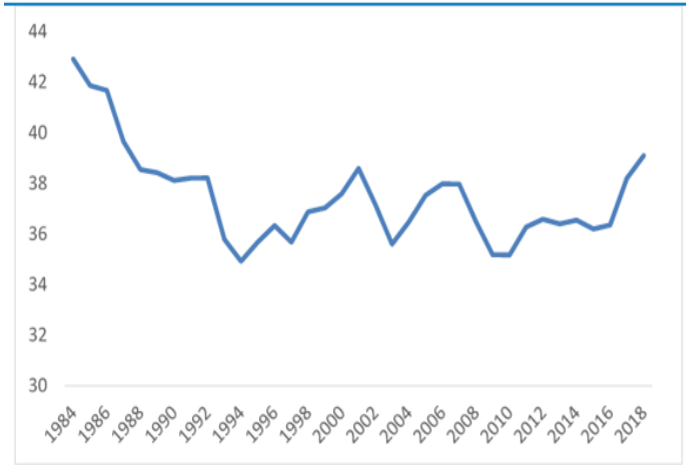
Whoosh…..

UK Sovereign Debt £bn(LHS), UK Sovereign Debt/GDP % (RHS)



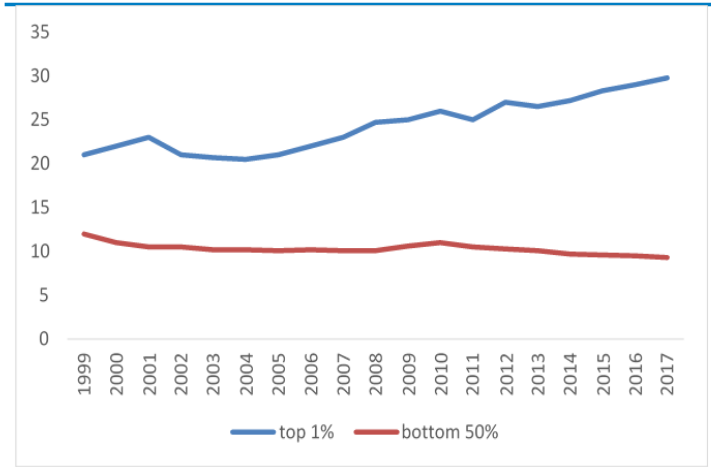
Source ONS

UK Tax as % GDP



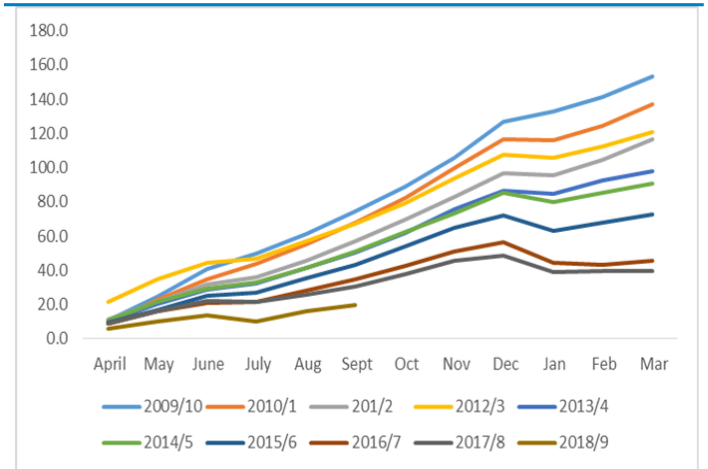
Source HMRC & Walbrook Economics

Shares of Income tax paid by top 1% and bottom 50% of earners



Source HMRC

UK Fiscal deficit- monthly accumulative £bn



Source ONS

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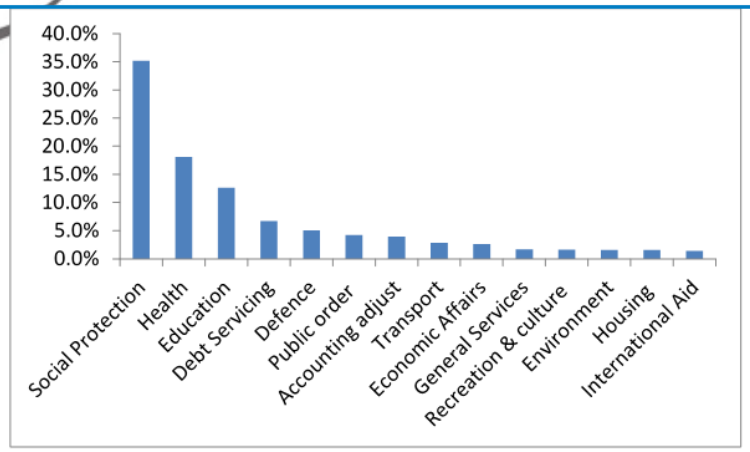
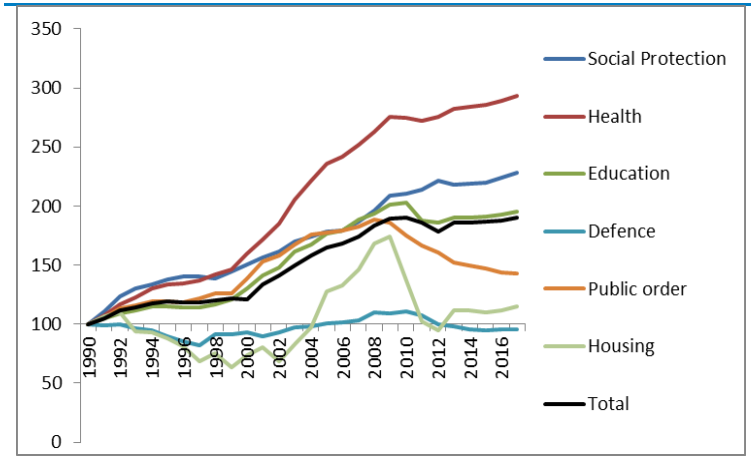
Fiscal – Austerity?

Sending by Department as % GDP 2016/7



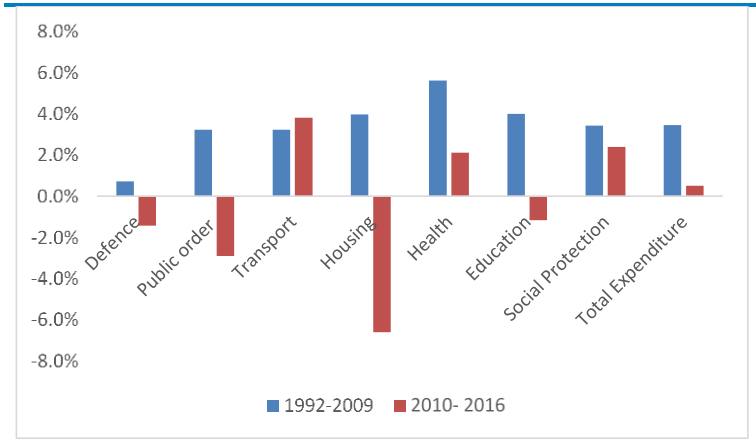
Source ONS

Departmental real public spending rises 1990- current % change



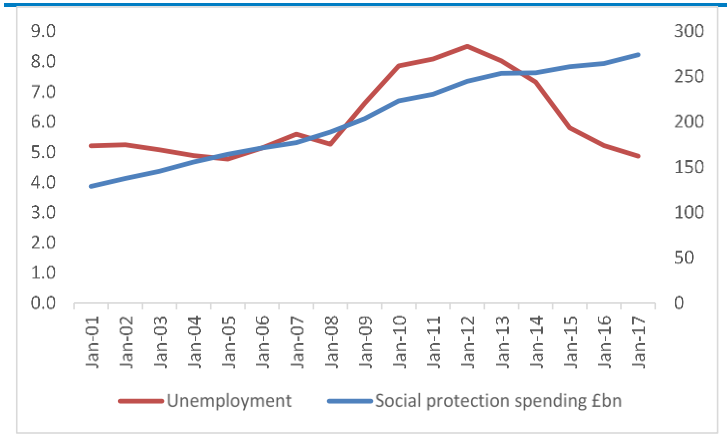
Source ONS

Departmental real rises in public spending comparison pre and post financial crisis pa real rise in spending %



Source Walbrook Economics and ONS

Spending on Social Protection £bn and Unemployment %



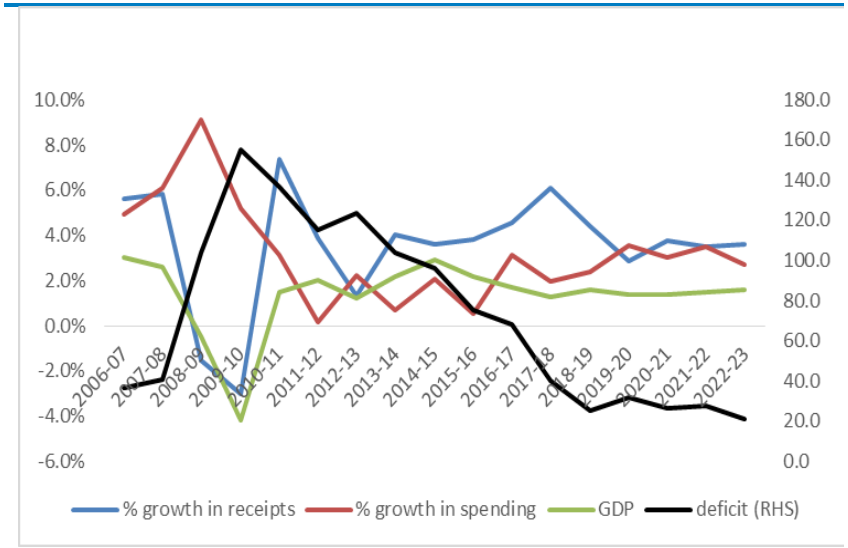
Source Walbrook Economics

Still precarious

- Public spending remains in structural growth.
- Tax receipts remain highly cyclical and dependent on a tiny number of people.
- For the UK in particular, investment is very dependent on global capital flows while other countries are adopting increasing tax competition (e.g. France, Portugal, Switzerland, Italy etc.).
- There is no serious political debate to reform spending other than re-arranging the deckchairs….
- It is not sustainable long term.

Three scenarios: one – the good

Scenario 1- OBR forecasts for tax and spending (growth y on y) on OBR GDP growth forecasts % (LHS) and deficit forecasts £bn (RHS)

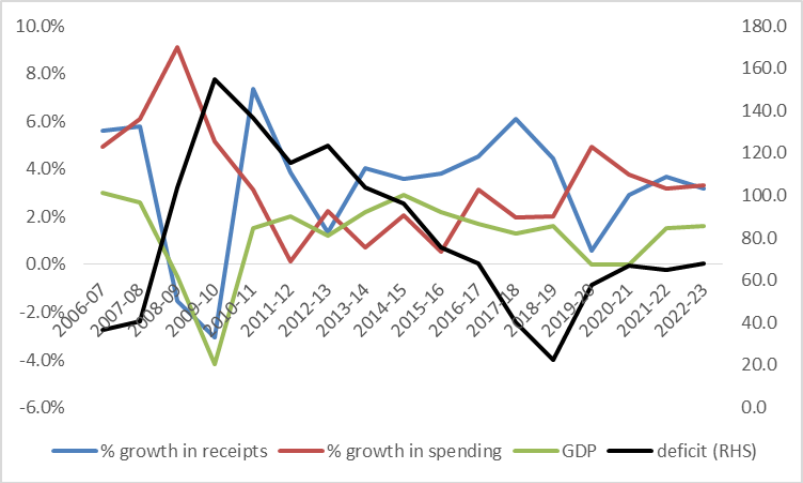


Source Walbrook Economics

- The OBR view of stable, but modest, GDP growth circa 1.4% pa.
- Annual fiscal deficit tends to zero by 2021-2 and the Government outstanding debt to GDP ratio slowly falls to 74% 2022/3 from a current 86%.
- This is the Chancellors view and coloured the recent budget.

Three scenarios: two – the bad

Scenario 2- Zero growth 2019/20 and 20/21, OBR forecasts thereafter
Implications for tax, spending and GDP growth (y on y % growth) and deficit £bn (RHS)

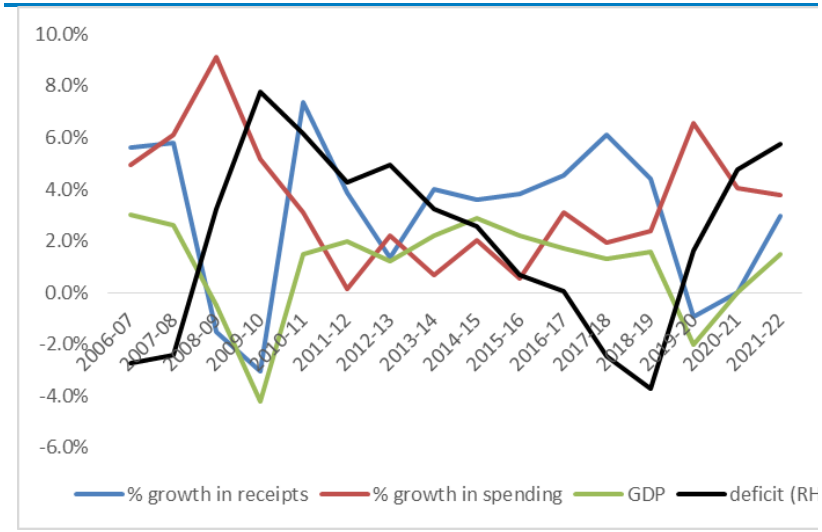


Source Walbrook Economics

- Scenario 2: GDP growth stagnates for 2 years: 2019/20 and 2020/1 then resumes to OBR trend thereafter.
- The annual deficit increases to circa £70bn by 2021/2.
- Debt/ GDP rises to circa 92% by 2022/3 from a current 86%.
- This scenario is manageable but with probable further tax rises and some spending squeeze.

Three scenarios: three – the ugly

Scenario 3- GDP-2% 2019/20, flat 21 then OBR thereafter implications for tax, spending y on y % growth) GDP growth and deficit £bn (RHS)

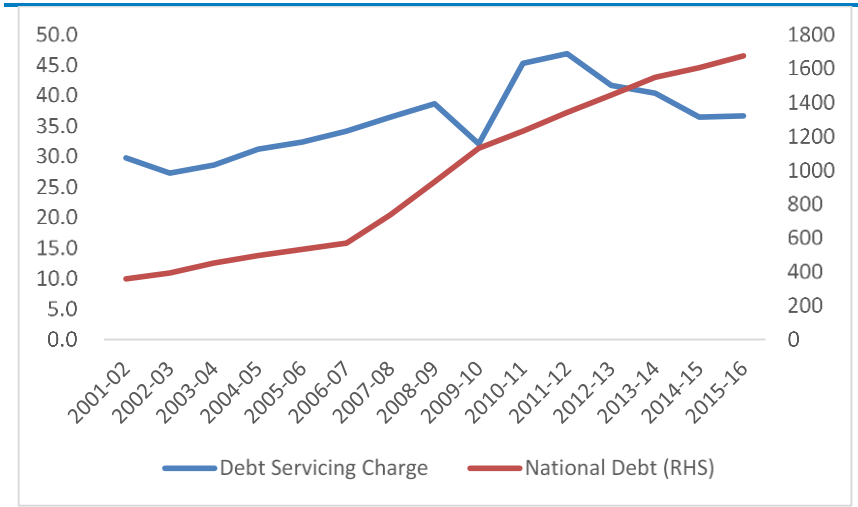


Source Walbrook Economics

- Scenario 3: Recession of 2% GDP in 2019-20 , flat year in 2020-1 then resumes to OBR trend thereafter.
- The annual deficit escalates to £132bn, or 7.2% GDP, in 2021-2.
- Debt GDP circa 115% by 2022/3 rather than the current 86% GDP.
- Very tough political decisions indeed and possible consequences for the yield curve……

The treadmill

HMG Debt Servicing Cost and National Debt £bn

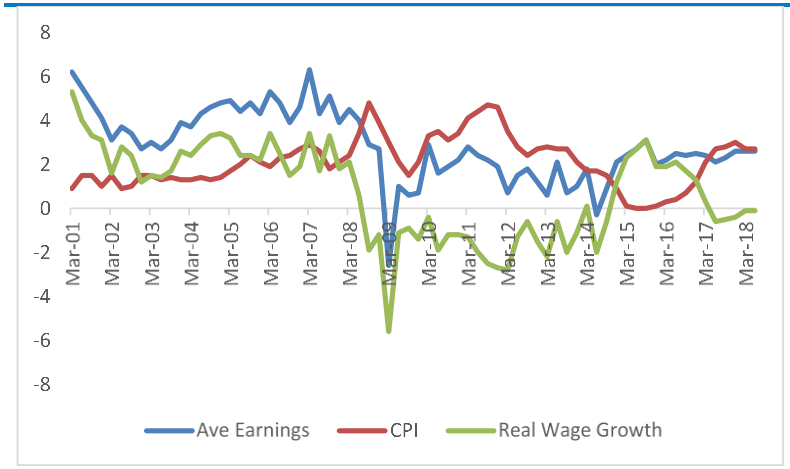


Source ONS

- National debt £330bn in 2001- debt servicing charge £29.1bn.
- National debt £1800bn today – debt servicing charge £36.7bn.
- This is a massive transfer of wealth from the private to the public sector.
- Average debt to maturity around 18 years.
- Within a decade around £100bn pa will need re-financed plus any new debt- perhaps £150bn pa.
- If 10 year debt costs 1.5% not an issue. If debt 'normalised' a big issue.
- Over 10 years a 2% rise in the yield curve would cost an additional £30bn pa, or half the education budget. At 5% its impact is unimaginable.
- How does HMG get off this treadmill without either inflating it away (unlikely) or maintaining super-low yield curve?
- This treadmill has big long term consequences for asset allocation/ wealth distribution/ investment and indeed political choice.

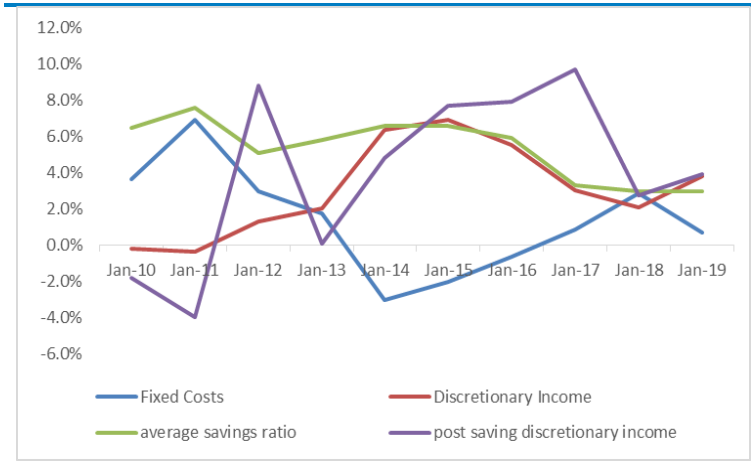
UK Consumer -also part of the bubble trade

UK CPI, Average and Real Earnings %



Source Trading Economics

Walbrook Economics Trend in household income % change



Source Walbrook Economics

Quite strong but only because of the low cost of debt……

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The (attempted) abolition of the cycle

- Simply put Western economies can not afford a recession in the short or medium term.
- Thus Governments and Central Banks are increasingly micro managing in an attempt to avoid the inevitable….
- This may sound enlightened and it is doubtless well intentioned but…..

- 'A put' on the market sends a signal to Banks/ business/ investors and consumers - leverage up.
- We would argue this micro management risks a bigger long term collapse as the imbalances increase with ever more extreme medicine required with the risk of a loss of monetary confidence.
- The 'new toy' of QE and negative real interest rates coupled with increased regulation across the economy limits 'the free society' and risks ever greater central control.
- This has profound long term implications for private investment/ wealth and the very free society we enjoy.
- Prior to 2008 clients viewed politics as pretty well irrelevant to investment conversations- today it is *the* conversation.

My advice to my eight year old

- Fill your boots.
- What could possibly go wrong?

So anywhere safe?

Global Comparatives- debt still rising

Debt levels by country and category - 2017

	Gov'ment	Non Financial	Household	total
Japan	214	102	57	373
Ireland	80	215	50	345
Belgium	121	163	60	344
Portugal	142	110	71	323
Greece	173	62	59	294
Netherlands	66	121	107	294
France	97	134	58	289
Sweden	43	146	86	275
Spain	98	100	63	261
UK	86	82	87	255
US	98	73	78	249
Switzerland	33	86	127	246
Italy	131	73	41	245
Australia	40	78	122	240
All	84	92	59	235
Germany	64	54	72	190

Source McKinsey

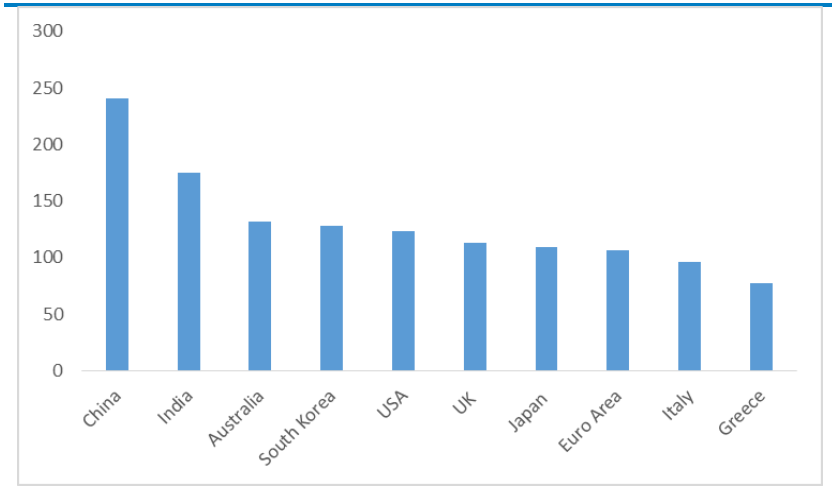
Debt levels by country and category – change 2017 on 2008

	Gov'ment	Non Financial	Household	total
France	40	25	9	74
Greece	65	0	3	68
Japan	63	-5	-2	56
Belgium	23	22	10	55
Australia	30	-6	16	40
Portugal	64	-9	-18	37
Switzerland	-3	11	23	31
All	18	10	-6	22
Italy	23	-4	2	21
Ireland	36	41	-58	19
Sweden	3	-3	17	17
Netherlands	9	9	-3	15
Spain	56	-27	-19	10
Germany	3	-2	8	9
US	26	0	-18	8
UK	31	-20	-7	4

Source McKinsey

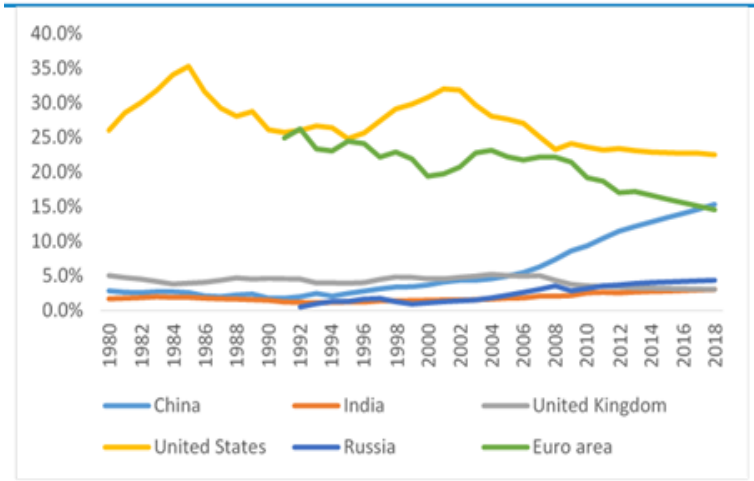
Power is shifting

Cumulative GDP growth 2009- current 2009=100



Source Trading Economics

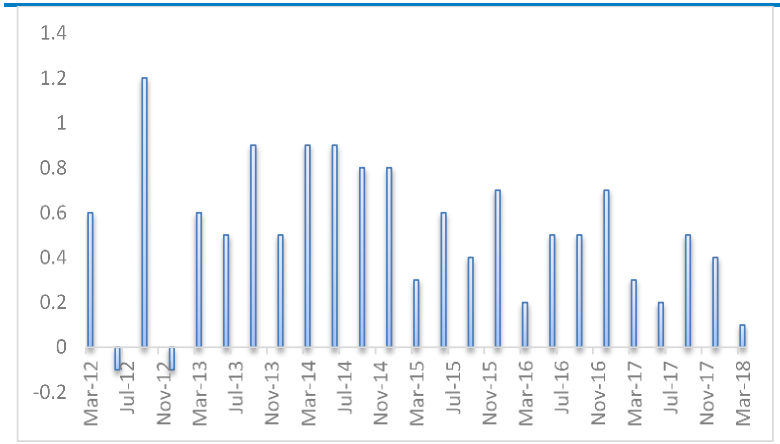
Share of Global GDP %



Source World Bank

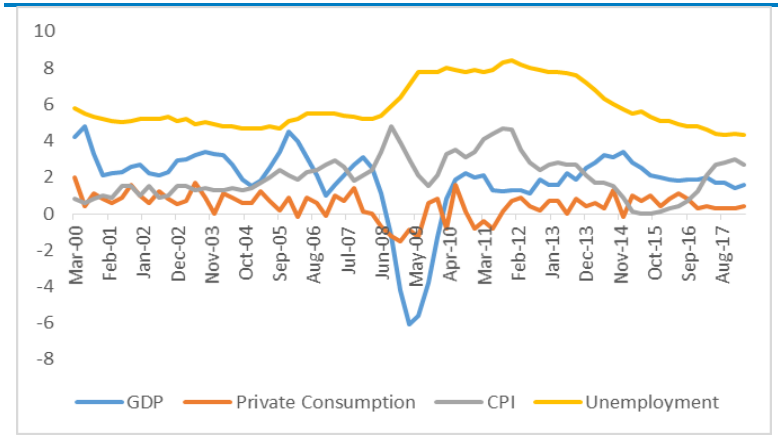
UK steady on speed

UK GDP q on q % change



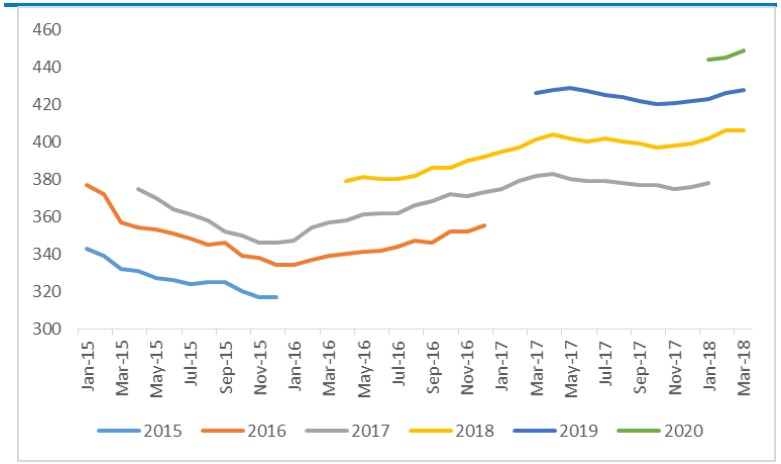
Source ONS

UK GDP, Consumption, CPI and Unemployment %



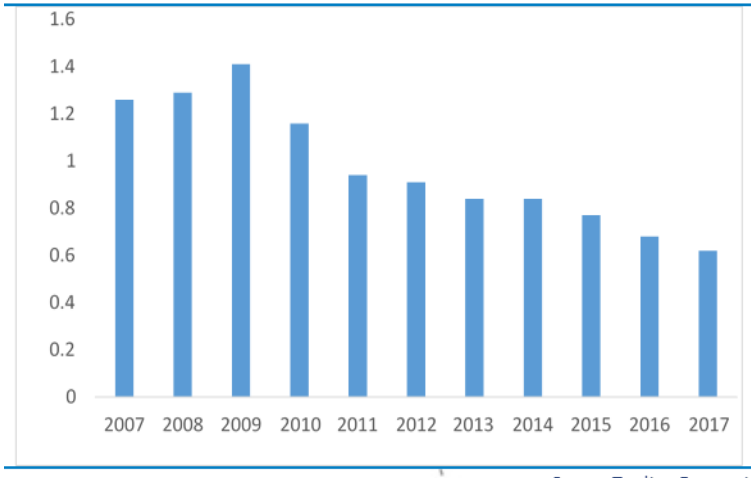
Source ONS

FTSE 350 EPS momentum



Source Trading Economics

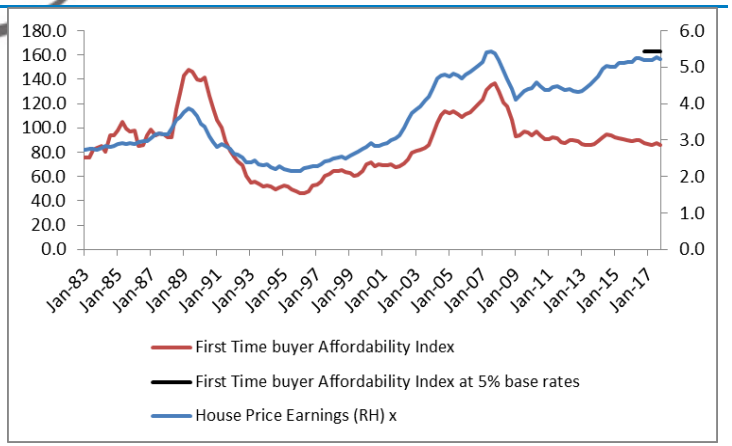
FTSE 350 Net Debt/EBITDA x



Source Trading Economics

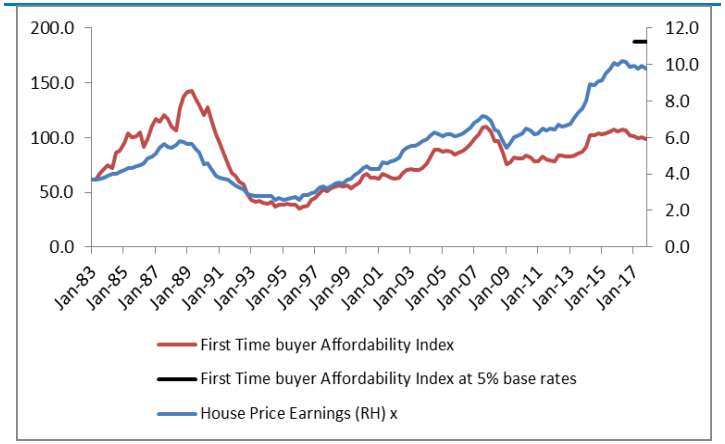
Policy results in an age of extremes

UK House Price Affordability



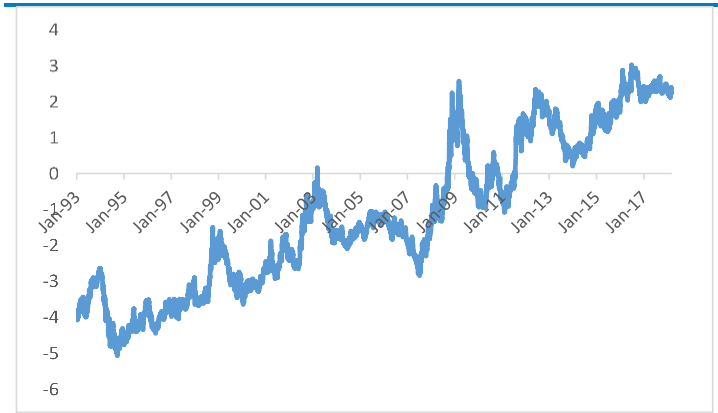
Source Nationwide & ONS

London House Price Affordability



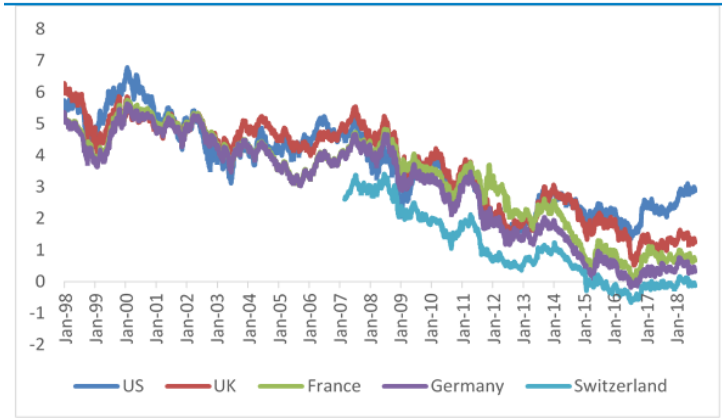
Source Nationwide & ONS

FTSE All Share historic yield minus 10 year benchmark gilt yield



Source Trading Economics

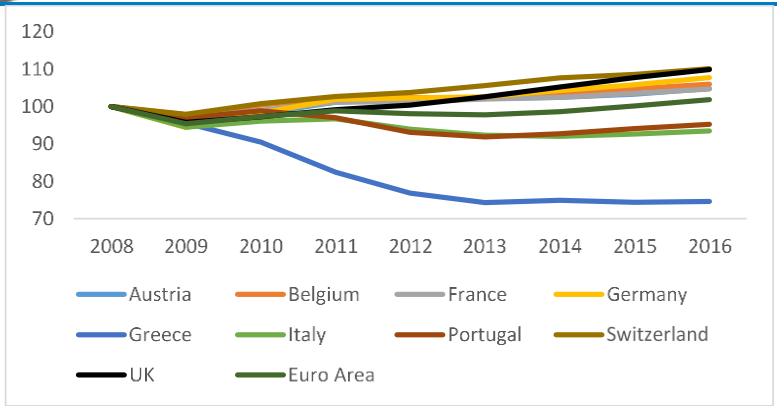
Key Global 10 year Sovereign bonds since financial crisis %



Source Trading Economics

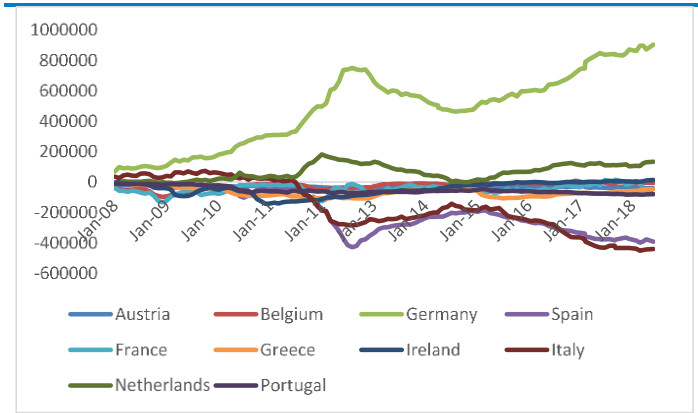
Eurozone- unhappy families?

Selected European GDP Growth Index 2008=100



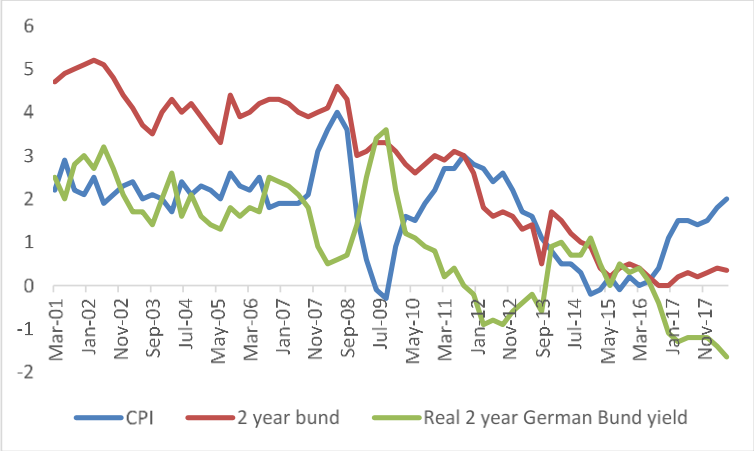
Source Trading Economics

Target 2 Selected Eurozone member-balances €k



Source ECB

German CPI, 2 Year treasury and differential %



Source Trading Economics

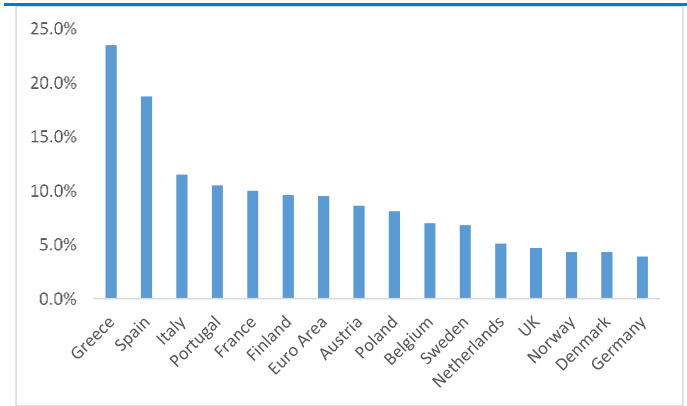
The price of Eurozone Money

Country	3 month swap	Bond Market (yields) 2 yr	5 yr	10 yr	30 yr
Austria	-0.36	-0.63	-0.10	0.58	1.38
Belgium	-0.36	-0.55	0.02	0.77	1.71
Denmark	-0.30	-0.62	-0.16	0.32	
France	-0.36	-0.44	0.09	0.74	1.62
Germany	-0.36	-0.63	-0.20	0.38	1.02
Greece	-0.36			4.19	
Ireland	-0.36		-0.05	0.94	
Italy	-0.36	1.03	2.44	3.41	3.95
Netherlands	-0.36	-0.69	-0.17	0.51	1.05
Portugal	-0.36	-0.15	0.68	1.87	
Spain	-0.36	-0.13	0.54	1.55	2.67
Sweden	-0.44	-0.45	0.06	0.59	
UK	0.81	0.71	1.00	1.42	1.84
US	2.53	2.86	2.97	3.14	3.38

Source Trading Economics

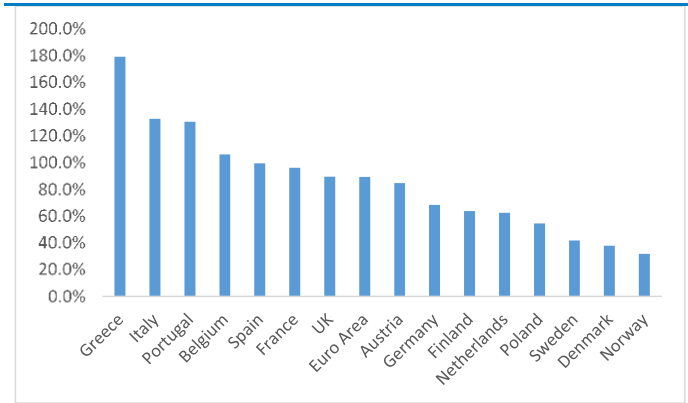
Eurozone- a never ending disequilibrium

European Nation Unemployment % workforce



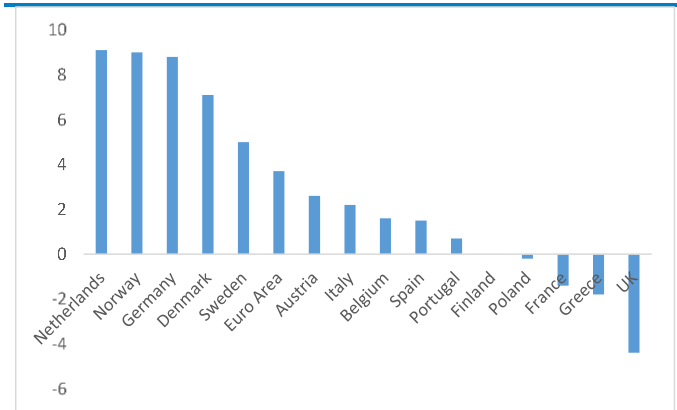
Source Trading Economics

European Nation Government Debt/ GDP %



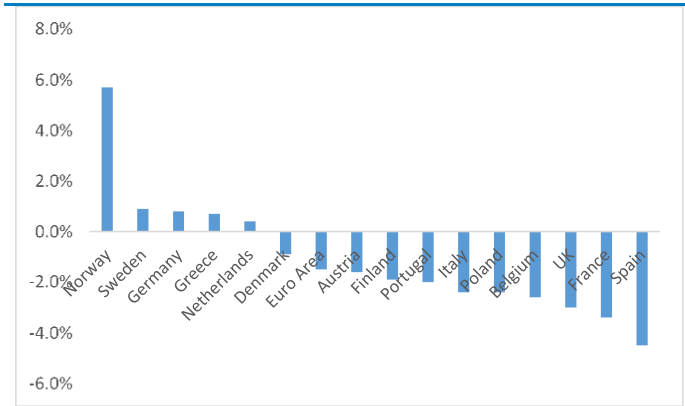
Source Trading Economics

European Nation Current Account as % GDP



Source Trading Economics

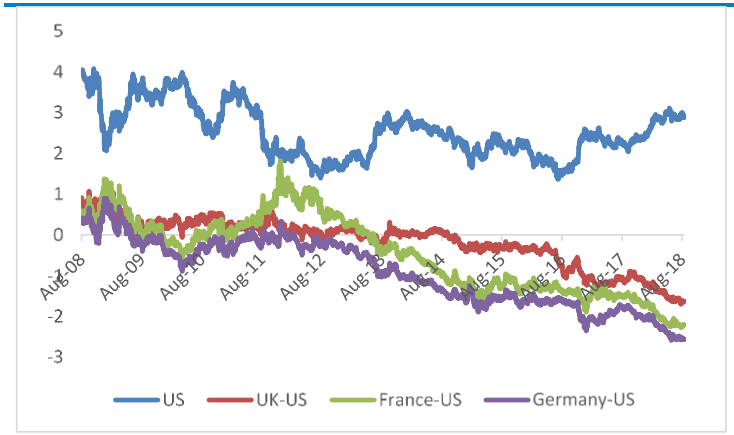
European Nation Current Annual fiscal deficit as % GDP



Source Trading Economics

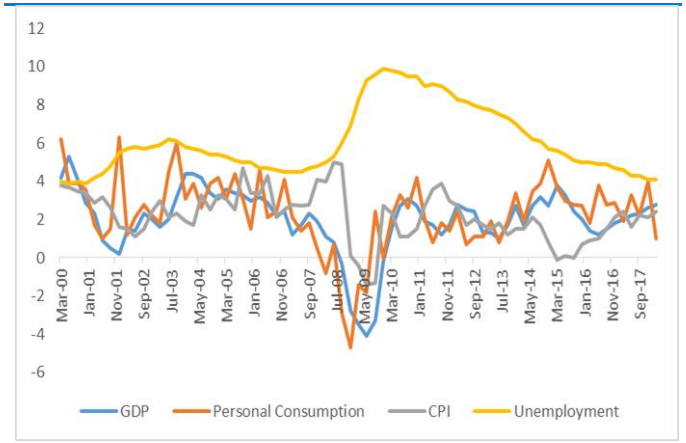
US- escaped?

Differential between US and key western 10 year sovereign bonds %



Source Trading Economics

US GDP, Consumption, CPI and Unemployment



Source Fed

- A degree of monetary normalisation returning.
- Supply side reforms – tax cuts.
- Less regulated labour market.
- Relatively low dependence on financial services.
- Highly diversified economy with leadership in new technology.

Emerging Markets- the powder keg

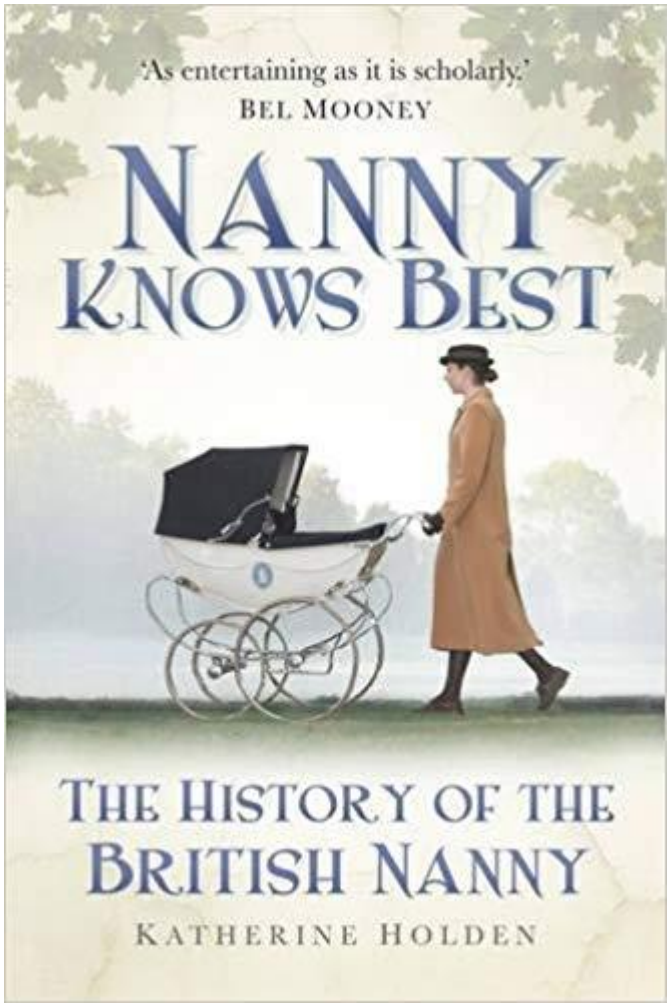
Currency movements rel to USD % - emerging markets in red

	1M	3M	6M	YTD
Euro Spot	(2.1)	(3.0)	(6.1)	(5.6)
British Pound	(2.3)	(2.9)	(7.4)	(5.7)
Swiss Franc	(2.1)	(1.5)	(1.4)	(3.1)
Japanese Yet	0.7	(1.1)	(3.4)	(0.4)
Russian Rouble	(1.2)	(5.0)	(4.3)	(12.4)
Turkish Lira	8.0	(10.7)	(26.2)	(31.0)
SA Rand	(3.4)	(9.8)	(15.3)	(15.9)
Argentine Peso	7.5	(25.8)	(44.1)	(49.3)
Brazilian Real	8.7	0.9	(5.1)	(10.5)
Chilean Peso	(5.3)	(8.0)	(11.5)	(11.3)
Columbian Peso	(6.6)	(10.6)	(12.8)	(6.9)
Mexican Peso	(6.8)	(7.2)	(6.9)	(2.2)

Source Trading Economics

- Emerging markets: the collateral damage of normalisation of US monetary policy.
- Massive USD borrowings susceptible to rate rises.
- Risks to emerging market currency, interest rate and economic stability.
- Some pain self-inflicted- Turkey, Venezuela etc.

Another side-effect: Regulation- going into overdrive



From 1950's *'the Man from the Ministry'*

to Francisco Goya

'the dream of reason creates monsters'

Regulation- the pace accelerates

- If it moves regulate it…..
- Financial Services – MiFID2
- Universities- Office of Students
- Even Calories!

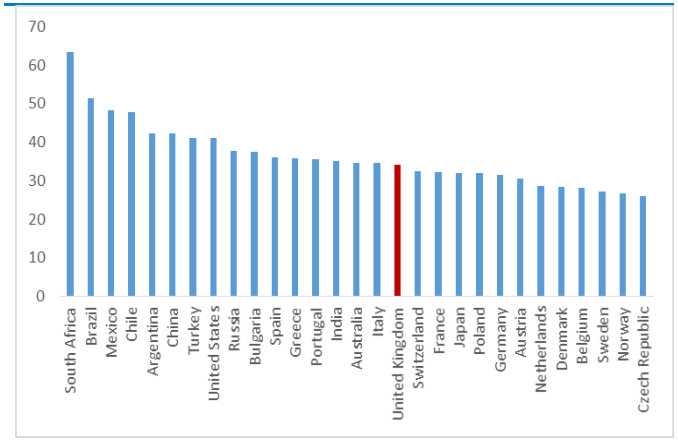
What happened to trust the individual to make the best choice?

Trade is about willing buyer willing seller not micro regulation masking as harmonisation that stifles innovation and helps create oligopoly.

Are we actually increasing risk by closing down on diversity of choice, policy and idea?

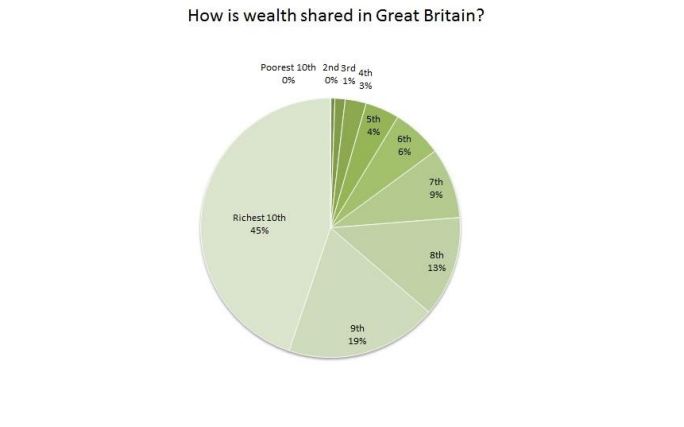
Busting some myths- Britain is not a particularly unequal society

Gini Co-efficient of inequality, 0= equality, selected nations 2012-4



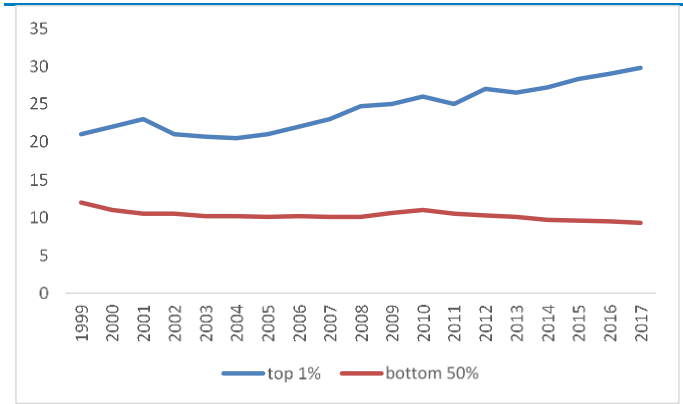
Source World Bank

UK Wealth Share by Decile %



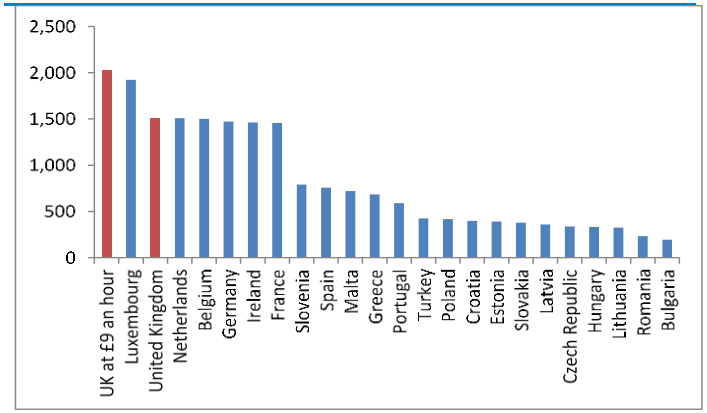
Source OECD & The Equality Trust

Shares of Income tax paid by top 1% and bottom 50% of earners



Source HMRC

Minimum Wage by EU nation (and Turkey) € per month and implied UK position at £9 an hour (assumed 40 hour week)



Source Eurostat and Global Britain

Walbrook Economics

Conclusions

- We have moved a long way from the classical liberal ideal espoused by Smith, Friedman, Hayek or even Keynes.
- The State remains in structural growth and the political debate crowded around unobtainable Rousseauian perfection and increasing Government action.
- The quest to control the economy through monetary experimentation, fiscal growth and regulatory zeal risks creating even greater distortions.

- Firstly, we need to understand that *the Great Moderation* was not some utopian memory, but an illusion of cheap money, leverage, public sector largesse and ultimately went pop.
- Second, the response may have averted a 1930's disaster but the UK and Eurozone are on a treadmill. Monetary normalisation to 'a free market' bond yield must be the medium term objective.
- Third, the State remains in structural growth. We need to tame the growth of spending, including withdrawal from certain areas, or face an ever increasing diminution of our freedom and liberty.

‘may we be governed quietly’

- There are many micro responses that could be adopted to strengthen current public provision while driving private choice and competition.
- Creating a stable long term environment for investment- not one where consumers are constantly having to second guess Government action on tax, pensions etc.
- Regulation – risk is part of the human condition. Attempts at harmonising the rule book increasingly reduce personal responsibility, trust and choice.
- We need to get back to Adam Smith’s idea of ‘willing buyer willing seller.’
- The private individual, or institution knows best. Regulatory growth is in over-drive and may be increasing systemic risk.
- political honesty and leadership and long term solutions, not short term crisis management.
- The urgent task is to trust the people, encourage personal responsibility and move to much more limited Government.

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