# RWC Equity Income

Q4 2015 Investor Letter | October 2015

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## Portfolio Managers

Nick Purves, John Teahan and Ian Lance

Nick Purves and Ian Lance were previously responsible for income-based strategies at Schroders, co-managing approximately £5bn within the income fund range since 2007. Nick and Ian joined RWC in August 2010 to establish the Equity Income franchise and were joined by John Teahan in September 2010. Since joining RWC the Team has developed low-volatility equity income funds with a focus on capital preservation. The team has over 60 years' investment experience between them and currently manage USD 4.4 billion in equity income mandates.

# With great power comes great responsibility - So will economists please stop playing God with other people's lives

## Introduction

As my daughter filled out her Personal Statement to apply for a university course in Economics she asked me 'Why do you think economics is an important subject to learn?' I struggled with this one for a while as in general terms I agree with whoever said 'If you laid all the economists end to end around the world, it would be a bloody good thing'[1]. Every time I read an economist banging on about perfect competition, rational behaviour and equilibriums, I wince at the fact that I wasted three years of my life learning such nonsense (I noticed a letter to the Financial Times recently from one of my former professors using CAPM to justify recent rises in asset prices so it appears little has changed). The jokes about economists tell you all you need to know about how lowly 'the dismal science' is regarded by other subjects (JK Galbraith said 'the only function of economic forecasting is to make astrology look respectable'). But then I had a flash of inspiration and I replied 'economics has the ability to impact the lives of more men and women in the world than probably any other subject'. Clearly if you have cancer then at that moment in time a doctor is the most important person in the world to you personally but when a small group of academics turned central bankers in the Eccles Building decide to move interest rates, it has the potential to send shock waves across the world and simultaneously impact the lives of millions of people. Equally it was the inability of the overwhelming majority of economists to forewarn of the dangers in the policies that led to the credit crisis that meant the eventual bust was such a shock and so damaging; in the US alone it led to 30m job losses, 6m foreclosures and a doubling of the national debt. When economics goes wrong, it can have staggeringly bad consequences and hence collectively economists have colossal power (although some individuals clearly have more influence than others).

## Economists are experimenting with unconventional policies

Those familiar with the Spiderman films will know that our hero was warned that 'with great power comes great responsibility' and economists would do well to bear that in mind. If you have that sort of power, then you shouldn't just start flinging around random economic ideas that have the potential to devastate the lives of billions of people (think of the percentage of the population impacted by US dollar move, e.g. pegs and EM) as if you were conducting some sort of laboratory experiment but that is exactly what has been happening for some time now.

- Willhem Buiter, Chief Economist at Citigroup has been calling for the banning of cash[2].

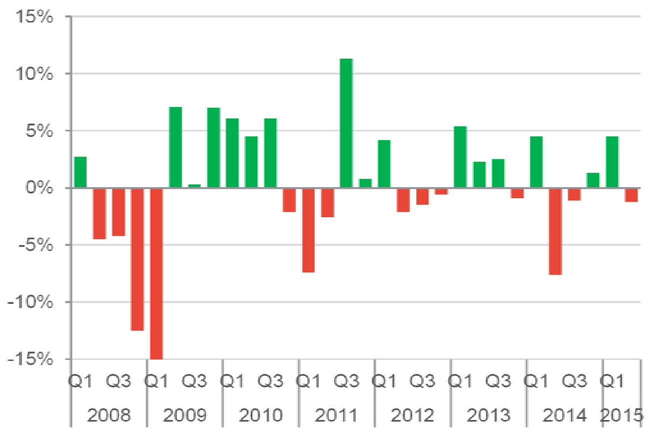
- Lord Adair Turner has wanted to print money to fund deficit spending for some time. Writing in The Financial Times in November of last year he said 'government deficits should temporarily increase and they should be financed with new money created by the central bank and added permanently to the money supply'[3]. He repeated the call on 6th October 2015 saying 'more radical policies such as……increased fiscal deficits financed by permanent monetization will be required to increase global demand.'[4]

- He has been supported in this idea by the Financial Times Chief Economist, Martin Wolf who seems to have been pushing the merits of money printing for several years whilst simultaneously downplaying the possibility of this policy having any negative effects once stating 'Only the ignorant live in fear of hyperinflation.'[5]

- Not to be outdone by the other inflationists, Adam Posen (co-author with Ben Bernanke of 'Inflation Targeting: Lessons from the International Experience') believes that the Fed should have expanded their balance sheet beyond the current $4 trillion'[6]. He is one of those advising Japan on the economic policy known as 'Abenomics' which doesn't seem to have worked well so far (see Figure 1) but Posen thinks they just need to do more. Some might have thought that expanding their balance sheet from $1.8 trillion in 2013 to $3 trillion today in a country with a debt to GDP ratio of 230% was enough, but not Mr Posen who believes 'Abe has good medicine but needs a stronger dose'[7]. One has to admire the brilliance of the Keynesians stance; even when their policies fail to produce the promised recovery, they are never wrong but merely proclaim that not enough has been done.

1. This was a play on the quote from George Bernard Shaw 'If the economists were laid end to end, they would not reach a conclusion'
2. Citi Economist Says It Might Be Time to Abolish Cash, Bloomberg, 10 April 2015
3. Printing money to fund deficit is the fastest way to raise rates, The Financial Times, 10 November 2014
4. Debt Déjà Vu, Project Syndicate, 6 October 2015
5. The Case for Helicopter Money, The Financial Times, 12 February 2013
6. We are all Lab Rats now: Adam Posen's Preposterous Prattle by Frederick Sheehan 28 September 2015
7. Abe has good medicine but Japan needs a stronger dose, The Financial Times, 25 February 2014

Figure 1. Japan GDP QoQ




Source. Bloomberg, 31 March 2008 to 30 June 2015, as at 12 October 2015

So the drumbeat of calls for more controversial economic policy has been in the background for a while but in the last few weeks the drum beat has been getting louder and the ideas whackier.

- 4th August 2015 Jeremy Corbyn called for 'Peoples QE' (another term for helicopter money) in which the Bank of England will print money to fund the governments favourite infrastructure projects.[8]
- 23rd August 2015 Financial Times Editorial also called for the scrapping of cash.[9]
- 13th September 2015 Financial Times columnist Wolfgang Munchau called for helicopter money.[10]
- 16th September 2015 Daily Telegraph's Ambrose Evans-Pritchard called for helicopter money and backed Jeremy Corbyn's economic policies.[11]
- 18th September 2015 Andrew Haldane, the Chief Economist at the Bank of England, has called for the banning of cash, negative interest rates and targeting 4% inflation.[12]
- 18 September 2015 Australia's Macquarie investment bank called for helicopter money.[13]
- 23 September 2015 Citigroup (there they are again) in a note entitled 'Cold Fusion' called for helicopter money as a way to "transform ineffective monetary into effective fiscal policy."[14]
- 25 September 2015 Charles Goodhart, a former member of The Bank Of England Monetary Policy Committee, called for scrapping of high denomination notes.[15]
- 28 September 2015 Sushil Wadhwani, a former member of the BoE's Monetary Policy Committee and founder of Wadhwani Asset Management, has called for helicopter money "If the bank does not consider helicopter money, then a government may come and do it in a less effective way."[16]
- 8th October 2015 Larry Summers, former US Treasury Secretary, called for money printing to finance asset purchases and fiscal expansion 'The central banks of Europe and Japan need to be clear their biggest risk is further slowdown. They must be prepared to consider support for assets that carry risk premiums…..they could achieve even more by absorbing bonds to finance fiscal expansion.'[17]

Now call me a conspiracy theorist but for so many economists to reach the conclusion that scrapping cash and helicopter money is now inevitable seems more than a coincidence. Either something suspicious is going on or maybe this is a modern Sherlock Holmes story where Professor Moriarty has launched an evil plot to bring down the world's financial system by slipping mind controlling drugs into the tea of the leading economists and created a 'Committee to Destroy the World'. Maybe my understanding of economics is not that good but I struggle with the concept that the problems of slumping global growth and gigantic debt mountains can be solved by simply printing money and scattering it across the masses with supposedly no adverse consequences. As David Stockman, Director of the Office of Management and Budget under President Ronald Reagan and twenty year Wall Street veteran says 'The reason there is a terrible financial cataclysm ahead is that mainstream thinking has

8. What do economists really think of Corbynomics?, The Economist, 04 August 2015
9. The case for retiring another 'barbarous relic', The Financial Times, 23 August 2015
10. Money-making scheme must be made of stronger stuff, The Financial Times, 13 September 2015
11. Jeremy Corbyn's QE for the people is exactly what the world may soon need, The Telegraph, 16 September 2015
12. How low can you go? - speech by Andrew Haldane, 18 September 2015
13. It Begins: Australia's Largest Investment Bank Just Said "Helicopter Money" Is 12-18 Months Away, Zero Hedge, 18 September 2015
14. "The Government Is Literally Paying Itself" - Citi Calls For Money Paradrops, Zero Hedge, 23 September 2015
15. Goodbye $100 Bill? Ex-Central Banker Demands All High-Denomination Banknotes Should Be Abolished, Zero Hedge, 25 September 2015
16. Corbynomics fuels debate outside radical circles, The Financial Times, 28 September 2015
17. Global economy: The case for expansion, The Financial Times , 08 October 2015

degenerated into outright quackery. Just read the drivel coming from financial journalists and pundits these days; and recall that the latter are little more than repeaters and amplifiers, passing along to their readers what politicians and policymakers are thinking and saying.'[18]

## The track record of economists does not give confidence in their ability to prescribe future policy

Many of the economists putting forward radical ideas for future economic policy do not have a great track record of getting things right in the past. We have highlighted before the staggeringly poor forecasting record of the US Federal Reserve (see our Q4 2013 Investor Letter here). A selection of Ben Bernanke quotes from 2008, on the eve of the worst financial crisis for eighty years, illustrates how unprepared the Fed was for the crisis despite employing hundreds of economics PHDs.

10th January 2008 – Response to a Question after Speech in Washington, D.C.

*The Federal Reserve is not currently forecasting a recession.*

27th February 2008 - Testimony before the Senate Banking Committee

*I expect there will be some failures [among smaller regional banks]… Among the largest banks, the capital ratios remain good and I don't anticipate any serious problems of that sort among the large, internationally active banks that make up a very substantial part of our banking system.*

2nd April 2008 – New York Times article after the collapse of Bear Stearns

*"In separate comments, Mr. Bernanke went further than he had in the past, suggesting that the Fed would remain aggressive and vigilant to prevent a repetition of a collapse like that of Bear Stearns, though he said he saw no such problems on the horizon."*

10th June 2008 – Remarks before a bankers' conference in Chatham, Massachusetts

*The risk that the economy has entered a substantial downturn appears to have diminished over the past month or so.*

16th July 2008 – Testimony before House Financial Services Committee

*[Fannie Mae and Freddie Mac are] adequately capitalized. They are in no danger of failing… [However,] the weakness in market confidence is having real effects as their stock prices fall, and it's difficult for them to raise capital.*

It is worth noting that Northern Rock was nationalised in February 2008 and Bear Stearns had already been taken over in March 2008 so at the time Bernanke was making these statements the system had already started to implode. On 7th September, two months after he made his reassuring statements about Fannie Mae and Freddie Mac, they were taken into conservatorship and on 15th September Lehman Brothers filed for bankruptcy.

So Bernanke was unable to spot a crisis that he was at least partly responsible for creating, but when the world fell apart and he bailed out the banks with taxpayer money, he was idolised by a lot of mainstream media (see 'America owes a lot to Bernanke' Martin Wolf Financial Times 4 June 2013).

The criticism of economists, only somewhat exaggerated, is that they are overconfident, unrealistic, and political. They claim a precision that neither their data nor their skill warrants. Too many assume that people are hyper rational maximisers of utility whose behaviour is thus simple to model. Critics like Nassim Nicholas Taleb, the scholar of rare events who wrote Fooled by Randomness and The Black Swan, says: "We have to build a society that doesn't depend on forecasts by idiotic economists." Says Paul Wilmott, a quantitative finance expert: "Economists' models are just awful. They completely forget how important the human element is."

## Not all economists failed to predict the crisis

It is also worth pointing out that not all economists failed to see the financial crisis coming. In 2003, I read the book Financial Reckoning Day by Bill Bonner which correctly forecast the crisis to come (Bonner followed this up with Empire of Debt in 2006 which was equally prophetic). Other people who famously got it right included Nouriel Robini, who presented his paper to the IMF in September 2006 warning of a nationwide housing bust, a brutal oil shock, a deep recession and a global financial bust caused by people defaulting on their mortgages. Other figures included James Grant who warned in 2005 that The Federal Reserve had created one of 'the greatest of all credit bubbles' in the history of finance. William White who was the Chief Economist of BIS warned about the systemic risk of asset and credit bubbles. For what it's worth, many of these people who 'got it right last time' are exceptionally worried about the state of the world today and believe we could be heading into another crisis (for example, see some of the most recent warnings from William White)[19].

18. David Stockman's Contra Corner, David Stockman, 05 December 2014
19. Central bank prophet fears QE warfare pushing world financial system out of control, The Telegraph, 20 January 2015

## Why did so few economists anticipate the crisis?

I see five factors that may explain the lack of success of economists:

1. It's a tough job

We should start by acknowledging that what economists are trying to do is next to impossible. An economy is a complex adaptive system which has thousands of different factors influencing it. Even if you could correctly forecast the majority of these factors (interest rates, currencies etc.) you then have to correctly anticipate the reaction to them of companies and consumers and how government policy might change. It would probably help if economists stopped pretending this was something that was even remotely possible.

2. Some economists are conflicted and their opinions are influenced

Whilst it shocks me to say it, many of those who didn't see the crisis coming were probably not interested in seeing it coming. The quote from Upton Sinclair has never been more apt

"It is difficult to get a man to understand something, when his salary depends on his not understanding it." — Upton Sinclair.

Directly or indirectly many of these people did not want to hear the cautionary message as it was not in their interests. The financialisation of the economy has meant there is a lot of money to be made by those who help the investment banks generate profits or even just turn a blind eye to their activities. In the same way that it paid the ratings agencies to rate subprime CDO's AAA, it paid many economists to argue for deregulation and free markets. In his book 'Other Peoples' Money' John Kay describes Larry Summers as being quite reasonable until he fell under the influence of Robert Rubin, the former boss of Goldman Sachs who went on to become Treasury Secretary. It was a cabal of Rubin, Summers and Greenspan who drove much of the deregulation of financial services that eventually backfired spectacularly but not before many bankers had been made rich beyond their wildest dreams. It was the same group that attacked Brooksley Born, the Chair of the Commodity Futures Trading Commission when she sought to extend the regulation of the derivatives markets. Summers went on to become Treasury Secretary and is now worth a reputed $40m although unfortunately the financial crisis subsequently proved Born's position on derivatives to have been a correct one. This seems to be one of the fundamental flaws of economics; those who prove themselves to be catastrophically inept at spotting a crisis don't seem to suffer the same reputational damage as a doctor or lawyer would. As Kay points out, Bernanke went on to become Chairman of the Federal Reserve, with Kohn as Vice Chair, Geithner became Treasury Secretary and Summers became Chair of the National Economic Council.

The Oscar winning film 'Inside Job' about the financial crisis highlights the extent to which many economists were conflicted. At one stage in the film George Soros says 'Deregulation had tremendous financial and intellectual support because people argued it for their own benefit…..the economics profession was the main source of that illusion'. The film then highlights both the way economists are influenced by jobs outside academia citing people like Ruth Simmons, President of Brown University, whilst also receiving an annual salary of $300,000 from Goldman Sachs at the time of the financial crisis and Laura Tyson, a Berkeley Professor who received $300,000 a year from Morgan Stanley. Glen Hubbard from Colombia Business School was on the board of Capmark, a major commercial mortgage lender that went bust in 2009. Perhaps even more cynical are people like Frederic Mishkin of Columbia Business School and former Governor of the US Federal Reserve and Richard Portes from London Business School. The Icelandic Chamber of Commerce paid Mishkin $124,000 for co-authoring his report, and paid Portes £58,000. It is not clear to what extent their willingness to assert the "highly professional" quality of Iceland's financial regulator and the basic stability of the banks was influenced by the size of their fees from an organization which had a strong vested interest in securing their favorable "expert" opinion. Given the recent history of Iceland, however, it is extraordinary that both economists reached such favourable conclusions shortly before the banks collapsed. One of the three Icelandic banks privatised in the early 2000s grew its assets at an average rate of over 90% a year from 2000 to the end of 2007, almost doubling its balance sheet every year. By 2006, tiny Iceland (with a population of only 320,000) had three banks in the world's 300 biggest. Its ratio of bank assets to GDP was the second highest in the world, slightly below Switzerland – after only six years' experience in international banking.

So when every well-known economist in town is putting forward policy which will undoubtedly help politicians continue to run deficits and help hedge funds and investment banks make money, it's hard not to be cynical about their motives. M&G's Richard Woolnough summarised this well: 'To get rich quick, the academics, central bankers and regulators have an interest to keep filling the punchbowl as they too are drinking from it'.

3. For many, their economics is an extension of their political views

Rather than examine the facts and try to put economic theory around them, many economists seem to start with a deep seated political view and then come up with economic theory to justify their political beliefs. A topical example is austerity; some more left leaning economists believe that there should always be a fully funded national health service and social welfare programme and that money must always be made available for that. Many of these economists also subscribe to the 'deficits don't matter as government debt can always be rolled over no matter how large it is' school of thinking or the 'money printing has no consequences, if banks can create money then why can't the government?' school. This immediately provides the economic rationale for how to fund this spending. Conversely some right wing economists seem to believe free markets always work best and constantly seek to provide the economic justification to that e.g. Larry Summers campaign to deregulate the US banking industry.

4. Economics appears to attract people with big egos which stifles debate

When asked how confident he was that he could control inflation, Ben Bernanke famously replied '100%'. Willem Buiter also is completely confident that helicopter money will not lead to inflation 'There are around 200 countries with fiat money and very few Zimbabwes. Hyperinflation only happens with major institutional breakdowns, while in most cases central banks know how to stop it' (This seems an incredibly disingenuous statement as surely Buiter should be asking 'how many countries with fiat money systems that introduced helicopter money subsequently ended up with high levels of inflation?')

For some reason, however, some of the leading economic thinkers seem to have gone beyond confident and ended up bombastic and rude. Now clearly not all economists have big egos, and I am sure there must be scientists in other fields with big egos, but for some reason economics does appear to attract people who are imbued with a sense of self-importance. The spat between Paul Krugman and Niall Ferguson is well documented[20] but as I was researching this paper and reading many of the blogs of mainstream economists, I have been staggered at the language they use with people who don't agree with them. When the BBC's Robert Peston recently suggested the performance of the UK economy justified George Osbourne's policies, economist Simon Wren-Lewis wrote on his mainly macro blog 'Sorry Robert, but this is just nonsense: complete and utter nonsense'[21] This tendency to dismiss out of hand and fling insults at anyone with an opposing view matters because it is hard for any science to evolve if dissenting voices are not given any consideration. One of the most expensive examples of this is described in 'Other People Money'. In 2005, at the Jackson Hole symposium, Raghuram Rajan who was then the chief economist at the IMF, queried the value of recent innovation in financial markets and warned of troubles ahead. His paper[22] was not well received and he was attacked by Don Kohn, the Vice Chairman of the Federal Reserve Board and most notably by Larry Summers who described Rajan's views as Luddite. Within a few years, it would turn out that Rajan was completely correct with his warnings and that Summers and co. would have saved the US a lot of money if they had been slightly less dismissive.

Another example of this is how several mainstream economists attacked a group of students at Manchester University who argued that the financial crisis was proof that conventional teaching of economics had failed and put forward ideas on improvements they would like to see. The movement then spread globally with students from many countries eventually coordinating to write a manifesto to change the teaching of economics in an open letter[23] to professors which went around the world. The proposals put forward were as follows:

i. Economics education should begin with the study of economic problems, where economic phenomena are outlined and the student is given a toolkit and must evaluate the strengths and weaknesses of how different theories explain different phenomena.

ii. Introduce pluralism so that students understand that different models and theories can be applied or are most useful in different situations. Students should be able to consider a variety of theories before forming judgements. This is important because economic theory is not universally applicable and much depends on institutional, historical and social contexts.

iii. Include the study of institutional power structures and politics. In doing so, students should be aware of the ethics of being an economist and a consideration of the ethical consequences of economic theory.

iv. Ensure that the philosophy of economics, or the more general philosophy of science, forms a core part of the curriculum. Students should be able to understand which assumptions are justified in a scientific theory and how rigorous the work to falsify a theory must be.

20. Krugtron the Invincible, Part 1, Huffington Post, 08 October 2013
21. Mainly Macro, Simon Wren-Lewis, 01 October 2015
22. Rajan R.G. 2005 'Has Financial Development Made the World Riskier?'
23. Post-Crash economics clashes with the 'econ tribe', Cameron KL Murray, 28 April 2014

v. Finally, provide students with an understanding of the historical development of a particular model or economic paradigm in order to contextualise the approach and provide insight into the problems it was designed to solve, and how context influenced its formation.

Now, these proposals strike me as eminently sensible and yet they were immediately opposed by many leading economists as summarised in this article which has links through to the attacks from Wren-Lewis, Yates, Farmer and Krugman with the latter stating that although 'few economists saw the crisis coming…..basic textbook macroeconomics has performed very well.'[24]

Now if this was just a backlash at a group of students in Manchester getting too big for their boots, it might be in part understandable to dismiss them, but former Chairman of the Federal Reserve, Alan Greenspan, was also admitting that the financial crisis had led him to question his doctrine.

"I discovered a flaw in the model that I perceived is the critical functioning structure that defines how the world works. I had been going for 40 years with considerable evidence that it was working exceptionally well."[25]

This lack of debate amongst economists is not healthy. For a science to progress, convention must be constantly questioned and this happens to be the subject of a new book by George Cooper called Money, Blood and Revolution. In the book, he examines the scientific advances of Copernicus (astonomy), Harvey (medicine), Darwin (evolution of species) and Wegener (geology) and looks at why these sciences appear to have progressed faster than economics. One of his key findings is that 'the leaders of a field almost always resist new ways of thinking, whereas younger students and interested laymen are often receptive to new ideas. History also shows it is the students and the layman who then drive the new ideas forward in the face of resistance from the old order'. This seems to perfectly sum up the situation with economics today.

5. Economists are guilty of group think

GMO's James Montier has been pretty scathing of the ability of economists for as long as I have known him. From his white paper, 'In defence of the old always'…

'However, attempting to invest on the back of economic forecasts is an exercise in extreme folly, even in normal times. Economists are probably the one group who make astrologers look like professionals when it comes to telling the future. Even a cursory glance at Figure 4 reveals that economists are simply useless when it comes to forecasting. They have missed every recession in the last four decades! And it isn't just growth that economists can't forecast: it's also inflation, bond yields, and pretty much everything else.'

Figure 4. Economists Can't Forecast for Toffee (GDP % YoY, 4q ma)


In another of his white papers 'The Idolatory of Interest Rates, Montier accused mainstream economists of group think.

'Group think is often characterised by:

– A tendency to examine too few alternatives;
– A lack of critical assessment of each other's ideas;
– A high degree of selectivity in information gathering;
– A lack of contingency plans;
– Poor decisions are often rationalised;
– The group has an illusion of invulnerability and shared morality;
– True feelings and beliefs are suppressed;
– An illusion of unanimity is maintained;
– Mind guards (essentially information sentinels) may be appointed to protect the group from negative information.'

Perhaps it is just me, but these traits seem to pretty much capture the nature of mainstream economics these days.

24. Post-Crash economics clashes with 'econ tribe', Cameron K Murray , 28 April 2014
25. From a speech to a congressional committee

### The most powerful economists in the world are central bankers

Unfortunately it appears that the most stubborn and dogmatic economists in the world are also those who wield the greatest power. I speak, of course, of the central banks, against whom I have the following objections.

1. Despite possessing immense power to impact everyone's lives, they are not elected. Nobody gets a chance to listen to Fed policy and vote on something that is going to have a huge impact on them.

2. They are also unaccountable. The members of the Fed get to spend $4 trillion on buying-back bonds, crushing the income on savings and inflating asset bubbles without ever having to answer their critics. Both Ron and Rand Paul faced huge opposition to their 'Audit the Fed' proposals. Type 'Audit the Fed' into Google and you will immediately find articles from The Wall Street Journal arguing that the Fed must be left alone to guard its independence. Even more insidious is that when one of the few independent Wall Street Journal journalists, Pedro de Costa asked Janet Yellen at a press conference about a Justice Department criminal probe for leaks at the Fed he was firstly blocked from attending future Fed press conferences and shortly afterwards 'left' The Wall Street Journal. At the next conference, he provided his fellow journalists with questions and supporting evidence to continue his line of enquiry but none of them obliged, presumably for fear that they too would be shut out in the future. This behaviour by The Federal Reserve is bordering on Orwellian.

3. They are independent in name only. The capture of many of the key positions of power in finance by Goldman Sachs is well known (Robert Rubin, Hank Paulson, Bill Dudley, Mark Carney, Mario Draghi, Romano Prodi…) but the current Bank of England Monetary Policy group also resembles a Canary Wharf Old Boys society. When the BOE was solely the lender of last resort, members having some banking experience was expected, but giving investment bankers the power to influence national monetary policy doesn't seem such a great idea.

| | |
|---|---|
| Mark Carney | Goldman Sachs |
| Ben Broadbent | Goldman Sachs |
| Kristin Forbes | Morgan Stanley |
| David Miles (recently stepped down) | Morgan Stanley |
| Dr Gertjan Vlieghe | Brevan Howard |

The following quote came from a letter to the Financial Times on 3 October 2015. 'It is a rare central banker who has not got roots in the global investment banks. These banks were culprits in the financial crisis and beneficiaries of central bank policy ever since. One does not need to be a conspiracy theorist to find this link irregular' - I completely and utterly agree.

4. They are pursuing goals which are unrealistic and frankly not useful to most people as well as being morally abhorrent. One of the Fed's mandates is price stability but then someone interpreted that as: prices must go up 2% per year despite there being no evidence whatsoever that real growth is any better at 0% inflation than 1% or 2%? What 2% inflation does do is facilitate a credit-oriented growth model in which debt is inflated away and money loses half its purchasing power in 35 years. Equally, I am not sure who determined that the bath tub of aggregate demand must always be full, nor why. I am also confused that we are trying to banish the economic cycle which seems akin to King Canute trying to stop the tide coming in.

On many levels, I also find the behaviour of the central banks morally reprehensible. This side of the central banks' policy was questioned by legendary fund manager Seth Klarman in one of his investment letters.

'What kind of policy is this: untested; inflationary; eroding free market signals, diverting more of the country's resources toward housing at the expense of priorities such as infrastructure, technology, or science and medical research; and inevitably only a temporary fix with no enduring benefit?...

Finally, we must question the morality of Fed programs that trick people (as if they were Pavlov's dogs) into behaviors that are adverse to their own long-term best interest. What kind of government entity cajoles savers to spend, when years of overspending have left the consumer in terrible shape? What kind of entity tricks its citizens into paying higher and higher prices to buy stocks? What kind of entity drives the return on retirees' savings to zero for seven years (2008-2015 and counting) in order to rescue poorly managed banks? Not the kind that should play this large a role in the economy'

5. They are using tools that don't work, a fact that is now admitted by the Fed themselves!! The Vice President of the Federal Reserve Bank of St Louis (Stephen Williamson) wrote in a new Fed white paper "There is no work, to my knowledge, that establishes a link from QE to the ultimate goals of the Fed inflation and real economic activity. Indeed, casual evidence suggests that QE has been ineffective in increasing inflation"

6. They are not considering the unintended consequences of their policies – as David Stockman explains:[26]

   'Namely, that the most powerful economic agent in the world is naïve, superficial, paint-by-the-numbers Keynesian bathtub plumber who has no clue about the incendiary forces that the Fed and other central banks have unleashed in the global financial system.

   Among the most insidious of these is that the corporate C-suite has been morphed into a stock trading room. The mountains of cheap corporate debt that have been sold to yield hungry asset managers has enabled companies to literally rig their own stock prices higher and higher via $2.5 trillion of buybacks since March 2009. At the same time, the Fed's wealth effects policy and free money to the carry trades has fulsomely rewarded buy-the-dips robo-machines and hedge fund gamblers, thereby ensuring that the cash register keeps ringing on executive stock options.'[27]

   Or maybe they are considering the unintended consequences and just don't care since these tend to be positive for the richest 1%, aka their former employers, clients and future employers. After leaving the Federal Reserve, Ben Bernanke left an almost indecent amount of time before joining the hedge fund Citadel.

7. When plan A fails, their only answer is to try more of it or a more extreme version. If the definition of insanity is doing the same thing again and again and expecting different results, then the Fed is clearly mad. QE1 was followed by QE2, which was followed by Operation Twist and then QE3 but seven years later the economy is still so weak that they are unable to lift interest rates above 0.25%.

8. They are staggeringly arrogant despite their patchy track records (although none of them believe they have patchy records as to listen to them speak, you would believe they had never been wrong about anything in their lives). The fact that Alan Greenspan's biography was called 'Maestro' whilst Ben Bernanke's autobiography is called 'Courage to Act' tells you a lot about how they regard themselves as does the latter's recent op-ed for The Wall Street Journal entitled 'How the Fed saved the Economy.'[28]

So what should the central banks be doing? I believe the central banks should drop their attempt to micromanage the economy such as the rate of inflation, unemployment or GDP growth. They should also get out of the market manipulation game.

'The statesman who should attempt to direct private people in what manner they ought to employ their capitals would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it' – Adam Smith The Wealth of Nations.

In my opinion, they should go back to their original role as guardians of the banking system who both monitor and warn of risks in the system ahead of time. In the event of a collapse, they should go back to being the lender of last resort to banks that are solvent and adhere to "Bagehot's Dictum" which states that in times of financial crisis central banks should lend freely to solvent depository institutions, only against good collateral and at interest rates that are high enough to dissuade those borrowers that are not genuinely in need. Those that fail to meet these criteria should be allowed to fail.

## Conclusion

Keynes hinted at the power that economists have when he stated: 'The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Practical men, who believe themselves to be exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back".

26. Current Federal Reserve Policy Under the Lens of Economic History: A Review Essay, Stephen D. Williamson, July 2015
27. 'Riding ZIRP into The Doom Loop – Monetary Central Plannings Dead End – David Stockmans Contra Corner 20 September 2015
28. How the Fed Saved the Economy, The Wall Street Journal, 4 October 2015

- Economists have a really bad track record as a group and the majority failed to anticipate the financial crisis. In 2008, the Queen, whilst opening a new building at The London School of Economics asked of the credit crisis 'If it was so large, why did no-one see it coming?' In 2009, Vice President Dick Cheney was asked the same question and responded, "Nobody anywhere was smart enough to figure it out, I don't think anyone saw it coming'. Whilst we know that this is not completely accurate, we do know that the overwhelming majority of economists were caught by surprise.

- What really concerns me is that economics as a science learnt nothing from the crisis or even worse than this, the key players have circled the wagons to protect their original beliefs. This intransigence of mainstream economists is beautifully summed up by James K Galbraith in his original essay 'How the Economists got it Wrong.'[29]

  *'Leading active members of today's economics profession... have formed themselves into a kind of Politburo for correct economic thinking.*

  *As a general rule - as one might generally expect from a gentleman's club - this has placed them on the wrong side of every important policy issue, and not just recently but for decades.*

  *They predict disaster where none occurs. They deny the possibility of events that then happen. They oppose the most basic, decent and sensible reforms, while offering placebos instead.*

  *They are always surprised when something untoward (like a recession) actually occurs. And when finally they sense that some position cannot be sustained, they do not re-examine their ideas. They do not consider the possibility of a flaw in logic or theory. Rather, they simply change the subject.*

  *No one loses face, in this club, for having been wrong. No one is dis-invited from presenting papers at later annual meetings. And still less is anyone from the outside invited in.'*

- If economics as a science is unwilling to admit its failings and at least consider new approaches, it suggests we are doomed to repeat our previous mistakes or possibly worse. At the end of 2007, the global stock of outstanding debt stood at $142 trillion at which point the world fell apart and most people thought we had learned our lesson and would never repeat this again. In the seven years since then the world has added an additional $57 trillion. Globally, the debate has clearly been won by the Keynesians and the 'deficits don't matter' group; government debt has grown at 9.3% annually and accounted for most of this increase in debt[30].

- What really worries me is that as their policies fail to deliver the expected results, economists are just becoming more and more extreme in their ideas. Interest rates are now zero or negative, research by the Fed shows that QE doesn't work so what do they do next? I am suspicious that the sudden burst of articles proposing radical new economic policies is a kite flying exercise from those who are concerned that something pretty nasty is coming down the pipe (a global recession maybe?).

- Of all this new economic thinking, the one that worries me the most is 'helicopter money'. Economists like Wolf and Krugman might think they are certain that money printing cannot cause inflation or some other ill effect but we know from recent failures of economists that nothing is that certain. These people will be only too aware of the history of Revolutionary France, Weimar Germany, 1970s Latin America and Robert Mugabe's Zimbabwe but they are so supremely confident in their ability to predict the future that they genuinely think it will be different this time. I am quite happy to acknowledge that I don't know what the consequences of these policies will be but we should all be honest enough to admit that it is a giant experiment and that the downside could be considerable. We could end up wiping out the savings of millions of people, blowing up the banking system or creating some other impact we have not even considered yet. Do economists truly reflect on this when they are throwing out their policy advice?

- Maybe I am too cynical but a small part of me wonders whether they would actually care about a creating an inflationary outcome as this would not be bad for everyone. Reviewing the book 'When Money Dies: The Nightmare of Weimar Hyperinflation' by Adam Ferguson in The Spectator[31], Money Week Editor, Merryn Somerset-Webb had this to say:

29. How the Economists got it Wrong, James K. Galbraith, 19 December 2001
30. McKinsey 'Debt and not much Deleveraging' 2015
31. The Spectator, 26 September 2015

*'However, the real reason to read When Money Dies is because loose monetary policy, while it hasn't hit CPI (yet), has given us a different kind of inflation — asset price inflation. Fergusson tells us that even though most people lose out from inflation, there are winners. The professional classes in Germany lost everything. Pensioners, bondholders and anyone else on a fixed income ended up destitute, their 'wealth shot away by war'. But speculators triumphed, as did farmers (who refused to sell their goods to city-dwellers for worthless paper). Foreign students did particularly well, buying up 'whole rows of houses out of their allowances', and members of state unions were able to strike until they got what they needed.*

*But those who did best were the industrialists who borrowed money for nothing, built up their businesses and used the collapse of the currency to funnel cheap exports abroad. This lot were passionately in favour of printing money. Why? It turned them into Europe's super-rich. At one point, says Fergusson, one group—Stinnes — controlled 19 per cent of Germany's production.'*

Does that sound familiar at all?

- There will come a time when people have just had enough of being told by central bankers and economists what they can and can't spend their own money on. Demand for physical gold and silver is reported to be surging whilst crypto currencies like bitcoin are gaining favour as people look to store their wealth in areas where it can't be got at by central banks and politicians.
- It feels to me that we could be sleep walking into disaster by following the same ideas of many of the economists and bankers who failed us so spectacularly in 2008 whilst simultaneously ignoring many of those who were right but this seems to have gathered such a momentum I am not sure what will stop it. The great and the good of the economics world are urging the politicians to run deficits and start dropping helicopter money which is encouragement they don't need!
- Maybe it will take something more severe than the 2008 financial crisis to turn the science of economics upside down, remove the absolute power of the central banks and the influence of politicians or maybe we will have to make incremental progress that only becomes apparent hundreds of years from now. For the moment, however, economics will remain a pseudo-science operating in a system captured by people who treat it as a real science and who therefore fail to appreciate the potential consequences of their actions.

*Unless stated otherwise all opinions expressed within this document are those of the author.*

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For further details see our Q1 Quarterly Letter 'Economics in One Lesson'

For another good summary of the struggle by students to change teaching of economics listen to 'Teaching Economics after the Crash'

http://www.bbc.co.uk/programmes/b04svjbj

# Contact Us

Please contact us if you have any questions or would like to discuss any of our strategies.


## RWC London

60 Petty France
London
SW1H 9EU
Tel: +44 20 7227 6000

## RWC Miami

2640 South Bayshore Drive
Suite 201
Miami
Florida. 33133
Tel: +1 305 602 9501

## RWC Singapore

80 Raffles Place
#22-23
UOB Plaza 2
Singapore 048624
Tel: +65 6812 9540

Email: invest@rwcpartners.com
Web: www.rwcpartners.com