The Absolute Return Letter
April 2012

You Can't Handle the Truth

Remember the scene in *A few Good Men* where Colonel Jessup (Jack Nicholson) and Lieutenant Kaffee (Tom Cruise) trade insults? Following some pretty intense questioning, Kaffee yells at Jessup: "*I want the truth*". With the deadly glare that only Jack Nicholson can muster, Jessop retorts: "*You can't handle the truth*".

I was reminded of this rather famous moment in film history when a long time reader of the Absolute Return Letter asked me recently: Why don't you tell the truth about the UK economy? Why don't you tell it as it is – that the situation in the UK is worse than it is in the eurozone? I decided to take up the challenge from the reader. I am not sure that I actually agree that the UK is in a *worse* position than most eurozone countries; it is worse in some respects but better in others. More about this in a moment.

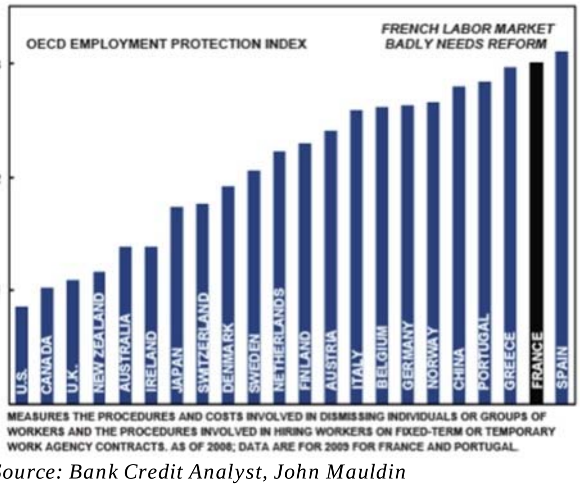
The UK government's strategy appears to be based on the age old philosophy that the best line of defence is attack. In recent months, Prime Minister Cameron has been unusually vocal about the shortcomings of the other major European powers at a time when everything is not plain sailing back home. On the major issues facing the UK domestic economy, Cameron and his government have been deceivingly quiet – perhaps because we can't handle the truth?

It is not all bad news

Back to the outlook for the UK. There is no denying that it is grim; however, and despite all the weaknesses of the UK economic model, it has two key advantages over most of its European neighbours.

Firstly, it is a currency issuer rather than a currency user, meaning that it has full control of its monetary and currency policies and can apply precisely the policy required at any point in time rather than being held hostage to the needs and requirements of the other members of the European currency union. As a currency user, it cannot *overtly* default unless it chooses to do so, although there are ways it can default *covertly* as we shall see later.

Chart 1: The UK Labour Market is Highly Flexible



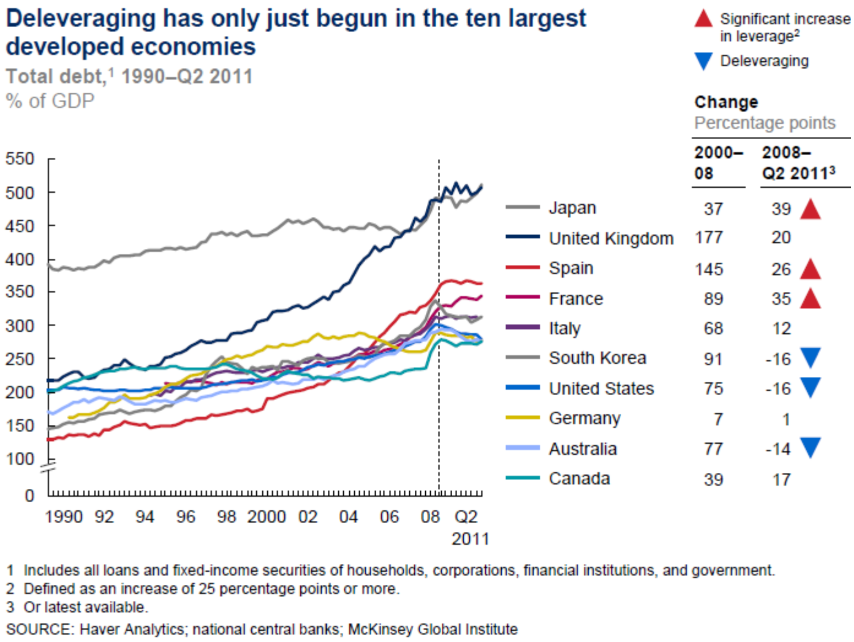
Source: Bank Credit Analyst, John Mauldin

Secondly, the UK has gone much further than most other countries in terms of restructuring its labour markets (chart 1), granting it key advantages over its European competitors many of whom are still saddled with labour market practices that do not stand a chance in today's environment where the market place for both labour and goods has turned truly global.

Private sector debt is huge

Having said that, the UK is in trouble. On several fronts. To begin with, the UK has not yet got its debt crisis under control. Despite talking the talk, debt has escalated further since the crisis erupted in 2008, making the UK one of the most indebted countries in the world (chart 2). When combining debt from the three main sectors - households, corporates and the public sector – of the major economic powers only Japan is now more indebted than the UK and it is only by a fraction.

Chart 2: Total Debt in 10 Largest OECD Countries



In truth, it is not the public sector that is highly indebted. In fact, most of Britain's debt problems originate from households and banks (chart 3) both of which have done little so far to address the problem[1]. Unlike in the United States where households have been deleveraging – to a large degree through personal bankruptcies – UK households have not reduced debt levels at all, mainly because banks have been relatively lenient, granting forbearance to troubled borrowers where perhaps foreclosure would have been a more sensible strategy. The Bank of England estimates that as much as 14% of all UK home loans are either delinquent or in some sort of forbearance process. Nobody really talks about this because nobody wants property prices to fall out of bed. Can we handle the truth?

The rehypothecation problem

One reason for the high level of leverage in the UK banking system is a poorly understood business practice known as rehypothecation. Hypothecation is another word for lending against some underlying collateral and is an every day event in the banking world. Rehypothecation is a somewhat more complex lending practice and presents a much bigger risk to financial stability. It typically occurs in the world of prime brokerage which is the department within banks that services hedge funds and other customers who wish to use leverage in their portfolios and/or short stocks.

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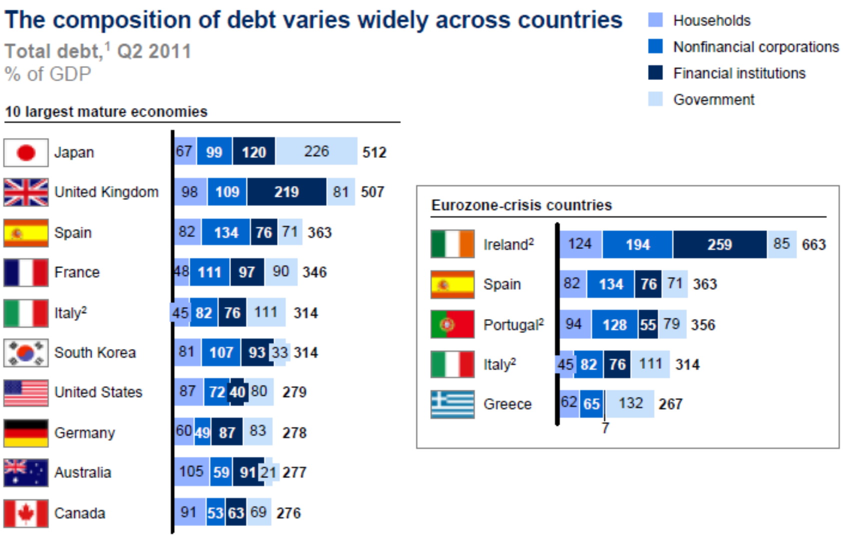
[1] *UK banks have in fact managed to reduce their leverage since 2008 but non-bank financial institutions have more than offset that trend.*
Source: "Debt and Deleveraging", McKinsey Institute, January 2012.

Chart 3: The Composition of Debt in Selected Countries



1 Includes all loans and fixed-income securities of households, corporations, financial institutions, and government.
2 Q1 2011 data.
NOTE: Numbers may not sum due to rounding.
SOURCE: Haver Analytics; Bank for International Settlements; national central banks; McKinsey Global Institute

Rehypothecation occurs when collateral posted by a client of the prime broker is re-used as collateral by the prime broker itself for leveraging its own book. It is perfectly legal; however, in the United States it is regulated activity under Rule 15c3-3 and is capped at 140% of the client's debit balance. An example best illustrates how it works.

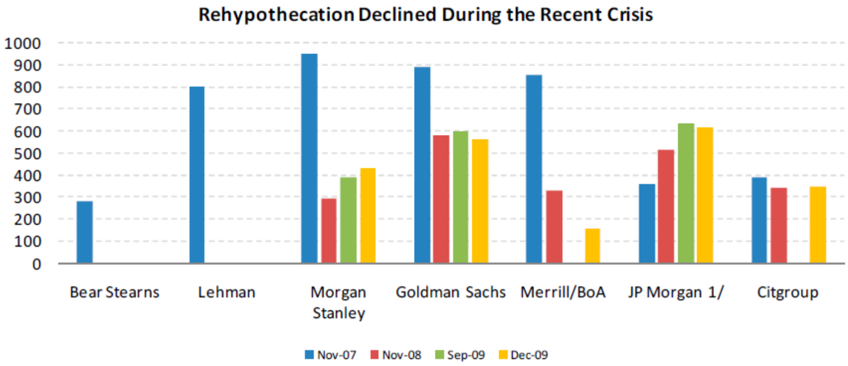
Assume a customer of the prime broker has pledged $100 million in securities against a debit balance of $50 million, resulting in net equity of $50 million. The prime broker can now rehypothecate up to 140% of the client's debit balance or $70 million. In other words, the prime broker can borrow $70 million against collateral that has already been used by the customer to secure the original loan and it doesn't stop there. Successive rounds of rehypothecation are permitted; however, if you think this is a bad practice, it is about to get a great deal worse.

In the UK, unlike the US, there is no cap on rehypothecation. No prize for guessing the game the global investment banks have been up to. By moving the majority of their prime brokerage activities from New York to London, it has been possible for investment banks to dramatically scale up of what is an enormously profitable business activity during good times but what has the potential to create havoc when markets go haywire.

Other than the multiple layers of leverage, which is bad enough in itself, a key problem associated with this business practice is the lack of segregation of client assets which many prime broker clients only came to realise when Lehman Brothers went bust. Clients of Lehman Brothers International Europe Ltd (also known as LBIE - the UK subsidiary of the US parent) found that their assets were not segregated when it was too late. So did clients of MF Global.

Following the demise of Lehman, prime brokerage clients began to read the fine print of the collateral agreements and many hedge funds now refuse to grant their prime brokers unlimited access to their assets. Chart 4 shows the decline in rehypothecation which has occurred following the Lehman crisis, but it remains a widespread practice which has the potential to cause massive problems at a time when you need stability more than anything.

Chart 4: Collateral Received at U.S. Banks Approved for Rehypothecation



Source: The (sizable) Role of Rehypothecation in the Shadow Banking System, IMF Working Paper WP/10/172

Let me repeat: There is nothing illegal about this business practice. However, more than three years after the messy bankruptcy of LBIE, hundreds of people remain involved in sorting out the chaos left behind by its prime brokerage unit. It is astonishing that no regulator or government has shown any interest in changing the rules, following what happened to clients of LBIE. Maybe they can't handle the truth.

The true impact of QE

Now to something altogether different. Here in the UK we have not been short of assurances from our government[2] that QE is good for us and for the economy. Companies will benefit from lower borrowing costs and savers will benefit from rising asset prices, or so they say. This is, however, an over-simplified account of what truly happens. Only the largest companies can access capital markets with small and mid-sized enterprises having to rely instead on bank finance the cost of which has not come down. In many instances, the opposite is the case.

But that is not the biggest problem. In the UK, most pension schemes are defined benefit (DB) plans (as opposed to defined contribution plans). In a DB scheme, liabilities are calculated by discounting all future payments back to present value, using the long bond yield as the discount factor. When bond yields drop, unless the pension fund has hedged this risk, the present value of future liabilities will rise.

The bad news is that the corporate sector in the UK has not been fully hedging this risk. By one estimate, UK corporates are £90 billion worse off as a result of the latest round of QE which has driven UK bond yields down to new lows. With unfunded pension liabilities in the UK already at around £300 billion before this latest bout of QE (approximately 30% of total pension liabilities), such a further shortfall is an unmitigated disaster (see here for details).

For individuals, the outlook is equally dire. Savers have seen their interest income plunge and the millions of baby boomers who will retire over the next 15 years will see the income from their annuity schemes being decimated as a result of lower interest rates.

If the government really wanted to support economic growth as it says it does, it wouldn't penalise the corporate sector to this extent. It would be buying gilts with short and medium term duration instead. It would possibly also be buying corporate bonds – in particular those issued by our troubled banks. And if the government really wanted to help the pensioners, it would issue longevity linked gilts instead of the 100-year

[2] *For the purpose of this discussion, I define government as including the Bank of England which is strictly speaking not correct. Please also note that the UK is merely an example of a wider problem. For example, many of the problems discussed here are also relevant to the United States.*

gilts (Ros Altmann's idea – not mine) which has been the talk of town recently as such bonds would help the pricing of annuities.

But the government will do nothing of the above. It will in all likelihood continue to pursue a policy of negative real bond yields at the long end of the curve, whatever the cost to the private sector. For the government such a strategy is a win-win. It can finance its debt extraordinarily cheaply and the negative real yields will allow it to accelerate the pay-back of its debt. For the rest of us, it is *default by stealth*.

Sadly, this is only a small part of the problem. Britain's pension model dates back to 1948. Some changes have been made to the model but the state pension age remains the same[3] despite the fact that life expectancies for both men and women have improved by some 10 years over the interim period. If you build a DB model on the assumption that, on average, your members will live 8-10 years beyond the day of retirement, and they instead live for another 20 years, you will by definition end up with a *major* problem.

In an attempt to address the future funding problem created by the improvement in life expectancies, the then labour government passed the Pensions Act 2007 which stipulates that the state pension age will be increased to 66 between 2024 and 2026, to 67 between 2034 and 2036 and to 68 between 2044 and 2046. As we say where I come from – this is akin to wetting your pants to stay warm!

The problem in a nutshell is that there is absolute *no appetite* in government for addressing this problem. What goes on is effectively a government endorsed Ponzi scheme where today's retirees steal from future generations. If I were 30 years old today, I would *demand* that the government change the pension system rather than go on the barricades to prevent change.

An obsession with AAA

Whereas the newish British government has shown little or no appetite for dealing decisively with the pensions crisis, it has said and done all the right things in order to protect its coveted AAA rating. I am just not convinced that it really matters. First of all, government debt is not the main issue in the UK; it is private sector debt which remains the problem. Given the combination of low interest rates and long average maturities of the debt outstanding, the UK government can quite comfortably support current debt levels.

Secondly, would it matter if the UK lost its AAA rating? I don't think so. The downgrade on US debt had no impact on the cost of borrowing over there. Financial markets still consider the US the benchmark of the world and the fact that US debt is now rated one notch lower means that AA+ is the new AAA. Financial markets are already tuned into the fact that most of those countries still rated AAA – including the UK – are almost certainly going to lose that rating in the next few years which means that bond prices already reflect that reality.

However, the British obsession with keeping its AAA rating risks derailing the domestic economy further. GDP growth has been slightly negative for the past two quarters so, technically, we are back in recession, and things are not likely to improve as long as the current policy is pursued.

As I have pointed out in previous letters, we currently find ourselves stuck in a balance sheet recession (see for example the March 2010 Absolute Return Letter here). Monetary policy becomes quite ineffective when that happens and fiscal policy should be expansionary to compensate for the loss of monetary efficiency. The policy currently being pursued in Britain is exactly the opposite – expansionary

[3] *This is actually not entirely correct. The state pension age for men remains 65 but a couple of years ago it was decided to gradually raise women's state pension age from 60 to 65 over the next decade.*

monetary policy and tight fiscal policy. Would someone please tell our government that they are walking down the road of self destruction!

Britain's dilapidated infrastructure needs urgent attention. We are desperately short of runway capacity at London's airports to support economic growth in and around the capital; yet the political establishment is happy to spend 15 years discussing the pros and cons of another runway at Heathrow. We live in one of the wettest countries in the world, yet we don't have enough water to meet demand in the south of the country. Our government encourages people to use public transport; yet it is the most expensive – and one of the most useless - public transport systems in the world.

I could go on and on. Now is the time to spend money on infrastructure. But the money must be spent wisely so that it enhances productivity and thus sow the seeds of future economic growth. Bond investors are intelligent enough to distinguish between such expenditures and the reckless spending that the previous government became known for.

Leadership is required

So, back to the original question: Is the outlook worse in the UK than in other European countries? It is probably fairer to say that the UK is plagued by a different set of problems than mainland Europe. Sadly, our problems here in the UK are actually manageable if only we had political leaders with spines that were not made up of boiled spaghetti. There should be a law against making a career out of politics. Most of the current generation of political leaders in the UK have gone straight from university into politics and they have no clue about most of the issues facing the people of our country and, even worse, they don't seem to care.

All they want to do is to cling on to their seat and you don't usually keep your seat if you implement policies which are right for the country in the long run but immensely unpopular when first implemented. Wasn't it the great Theodore Roosevelt who uttered the famous words (and I paraphrase): *You can do what is right for the country or you can do what is right for the people but you can't do both.* It has never rung truer than now.

Investment implications

Current UK economic policy is all but guaranteeing low growth for several more years, meaning that the Bank rate, currently at 0.5%, will probably stay low for some considerable time. So will yields on gilts unless there is an exogenous shock to the economy, resulting in a rapid escalation of inflationary pressures, which is quite unlikely to happen in a balance sheet recession.

Many investors predict rising bond yields in the years to come, mainly as a result of the massive amounts of QE in recent years. I don't think it is that straightforward. The combination of (i) ongoing deflationary dynamics emanating from continued deleveraging in the private sector which is only going to intensify, (ii) the pension sector's enormous appetite for anything with a half decent yield and (iii) the strong incentive to maintain negative real interest rates, is likely to keep a lid on bond yields.

UK equities are quite attractively priced which should offer some considerable downside protection even if the economy continues to weaken. However, the lack of economic growth is likely to limit the upside potential. Our view thus remains unchanged. In the short to medium term, UK equities are likely to be range bound. In the long run, there is considerable upside potential.

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4 April 2012

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