Thinking notes for ARC-UK Oct 7

Title: “Why The Pound Got Pounded”
Subject: Financial crisis in the UK
Financial crisis in the UK is self-inflicted wound resulting from inflation and energy policy
Contrast: UK needs lower interest rates and net zero

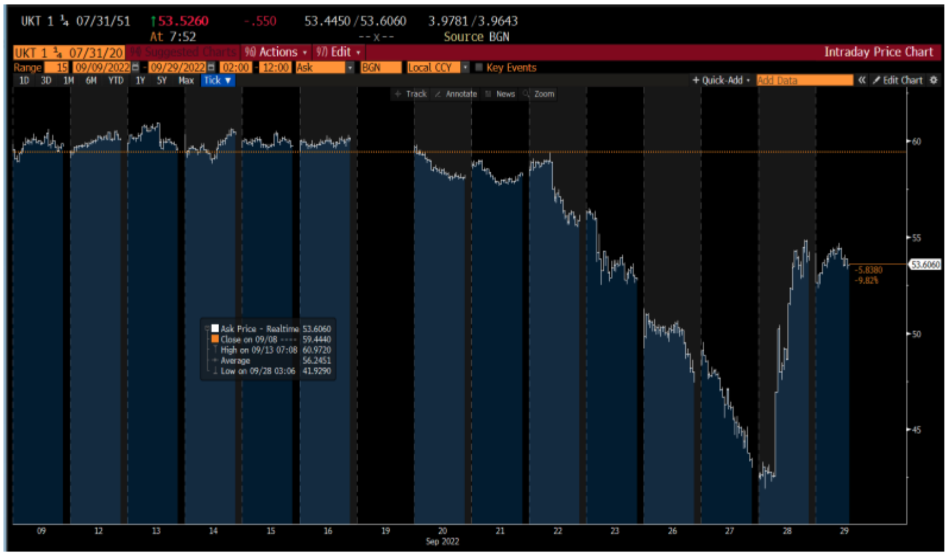
Hi everyone, welcome to Finance Friday on the ARC-UK YouTube network. I am HardmoneyJim speaking today (as usual for this time of year) from beautiful Jackson Hole, Wyoming. Fall is a beautiful time to be here.

Here’s a photo of the entrance to the town square, just a couple of blocks from where I’m sitting. Those are elk antlers forming the arch, collected from the woods and the prairie by the local Boy Scout and fashioned into a unique arch. There are four of these arches, one on each corner of the town square, and another one that you walk through right after you get off your flight at the Jackson Hole Airport.

As you can see, the fall colors are really fine this year. And by the way, I want to assure you that no live elk were harmed in making these arches.

OK a lot is going on in the financial world, so it’s hard to decide what to talk about. But there was an interesting incident about a week ago, an event that seemingly came and went; some people didn’t notice it, but I think it is a bellwether for other things to come, so I thought we would all benefit from talking about it. And as we’ll see, this incident related directly to my favorite economic subject, that is, money creation and its consequences.

The incident I am speaking of was the near blow-up in the UK financial system last week. Did any of you read about that? It was like a flash crash that might have been a disaster if the Bank of England had not come riding to the rescue, checkbook in hand. The incident is a sign of our times, and we need to have a basic understanding of it if we hope to understand the consequences of money creation and how to prepare ourselves for those consequences.



What happened was only partially visible to the casual observer, but clear to bond market observers. Here's a hard-to-see graph of the daily price of the UK 30-year Gilt from Sep 9 to Sep 29. ("Gilts" are the UK equivalent of US Treasury bonds; they are bonds issued by the Exchequer, the UK's treasury). You can see the daily price was declining from about September 15, reaching a low on September 26. That is a precipitous price move in such a short time. But then the bottom fell out of the UK Gilt market. There were practically no buyers for 30-year gilts except at rates nearing 7-8%. Before that could happen, the Bank Of England stepped in and offered to buy huge amounts of Gilts to support the price. Understand, these same bonds had been trading to yield 1% a year ago and 2% only two months ago.

Market price of a 30-year bond with a 2% coupon, pays semi-annually

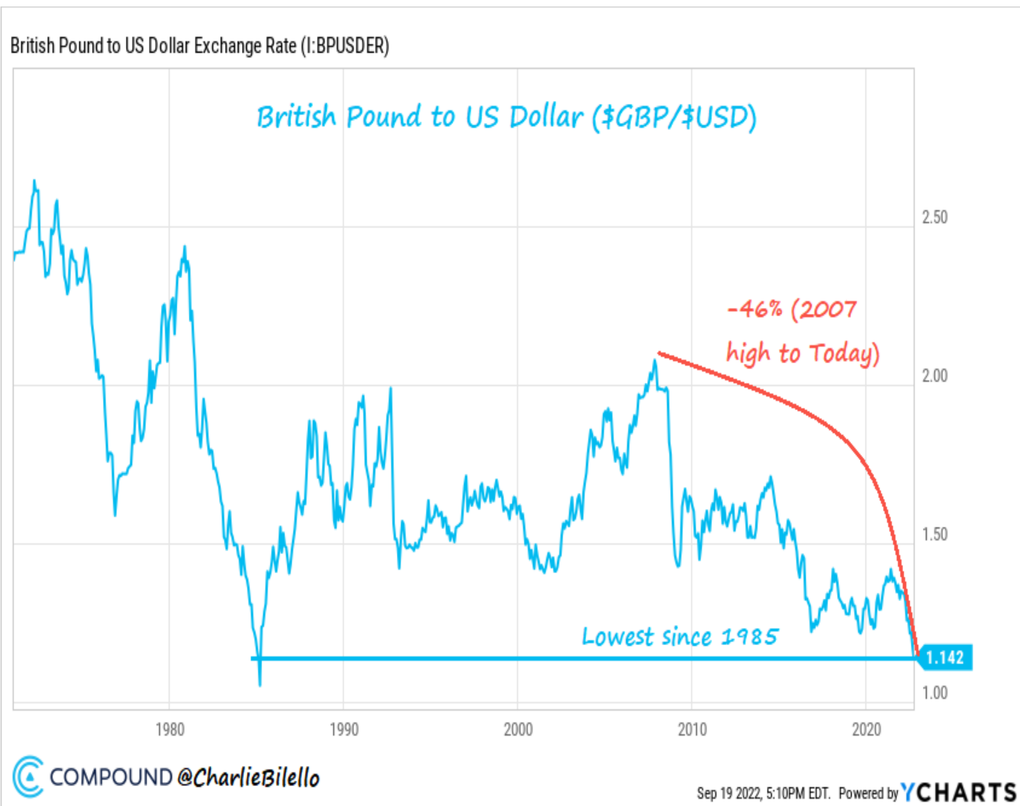
Market interest rate (%)	Market price of bond
3.0	80
4.0	65
5.0	53
6.0	44
7.0	37

In case you are not familiar with how sensitive long-term bonds are to changes in market interest rates, here's a little chart to illustrate the relationship. A 30-year bond with a 2%

coupon that previously traded at 100% of its face value falls to 80 when the market value goes to 3%, to 65 when the market rate goes to 4%, and to only 37% of its original value when the market rate goes to 7%.

Ordinarily, central banks do not intervene in the bond market just because of price moves. They do intervene when big price moves are causing stress and potential failure of some large financial entity, like a too-big-to-fail hedge fund or a bank. So someone owned these bonds and was under stress due to the drop in market price. Who was the failing entity? We didn't know right away. But we know now, and I will get to that in a minute.

To give you the economic backdrop for this mini-crisis, let's mention some of the interrelated background issues, including the exchange rate of the Great Britain Pound (GBP), the BoE's QE policies, consumer price inflation, interest rates, UK government spending, and national debt.



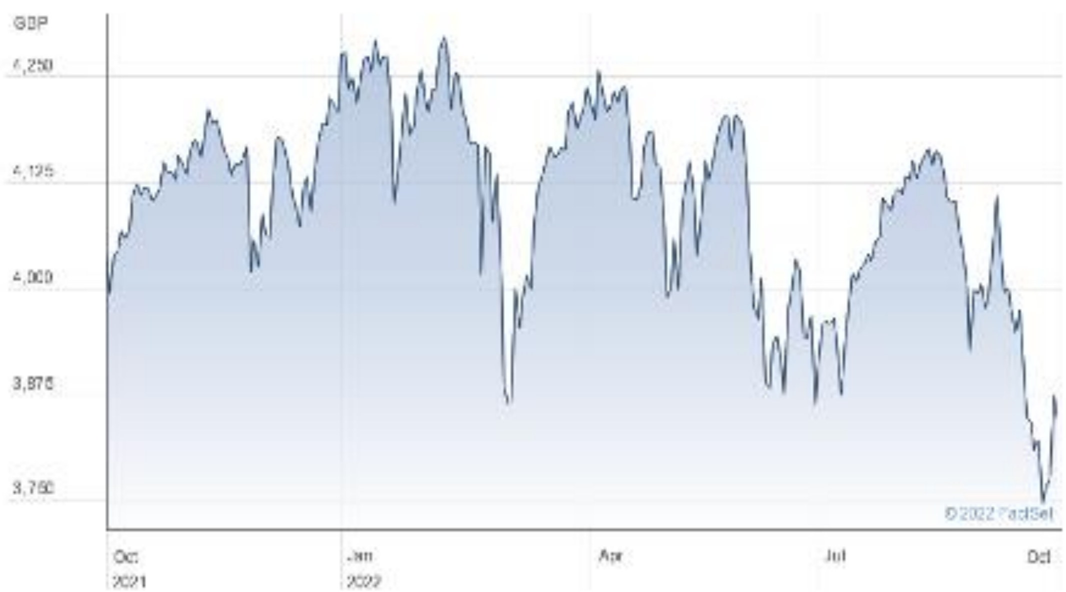
Let's start with the UK pound, which has been very weak, versus every other primary currency. Here is the Great Britain Pound (GBP) vs. the US dollar (USD) exchange rate, going back 50 years, and you can see it is at or near its all-time low. The GBP is among the worst-performing currencies vs. the dollar this year. Over the last year, the UK pound and Japanese yen are down over 20% versus the dollar, while most other major currencies declined in the range of 10% to 15%. So the pound is behaving like a third-world currency.

The weakness of the GBP is due to several related factors, so let's consider the most important ones. The value of a currency is generally driven by the expectation of what you can buy with that currency in the country where it is legal tender. So what are the prospects for future spending of UK pounds in the UK? I am talking not about what really will happen to the GBP but what the market is signaling it thinks will happen to the pound.

The question we want to ask is, why might you want to accumulate the GBP?

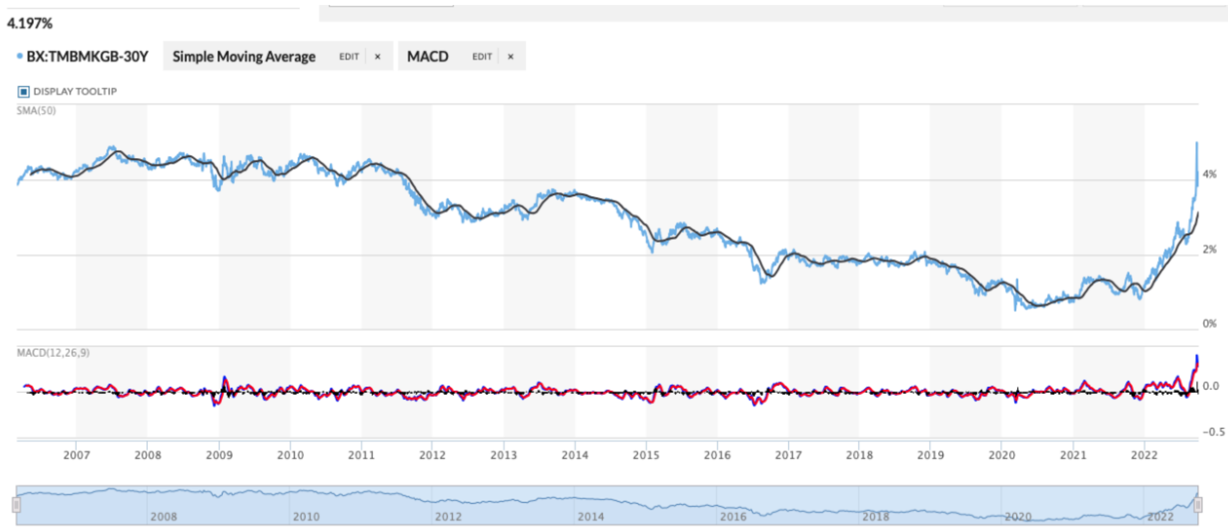
First, the UK economy has been flat, with low growth, high energy costs, and the possibility of energy shortages this winter. Do you want to live in the UK and earn GBP, given these poor business prospects, a looming energy shortage, and facing a cold winter with no heat? At the margin, maybe not unless the value of the pound improves, ie, unless it will buy more. The point is, a poor economy reduces demand for the GBP.

I'll add, the recent GBP weakness is at least partly because of net zero energy policies that have driven up energy costs to levels never previously imagined. This adds to the poor outlook for economic growth and business prosperity in the UK. So that limits or reduces the demand for GBP.

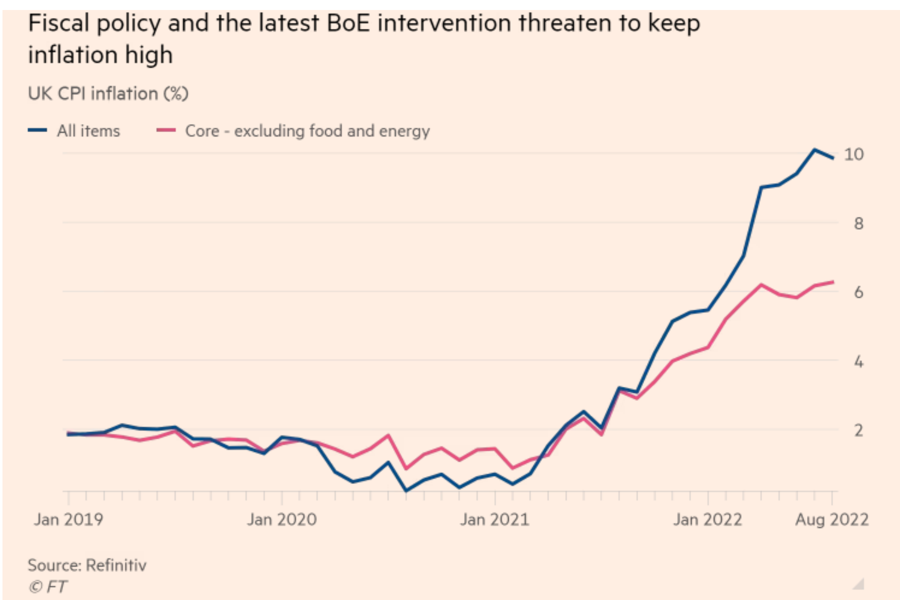


Here is the UK stock market (FTSE-100) last two years

Next, do you want to get some GBP so you can buy UK Stocks? Probably not. UK stocks have performed poorly. That reduces demand for GBP.



Next, do you want to get some GBP so you can buy some UK bonds? Probably not. This is a record of the yield on the 30-year UK gilt. See the steady decline until just a year ago. UK interest rates have been so low that you earned practically nothing. The yield declined to as low as 50 bps during the pandemic. So, clearly, low interest rates reduce demand for the GBP.



Finally, do you want to hold GBP in a UK bank account that pays almost no interest? Look at CPI inflation in the UK. At 10%, it is higher than the USA where CPI inflation is 8+%. Your money is worth less every day. Note also that if prices rise at 10% while the UK bond only pays 2 or 3%, that is a totally losing investment proposition. So inflation, along with a low real rate of return on investment, reduces demand for GBP.


DAILY STAR

THOUGHT FOR THE DAY

JOIN FOR FREE

Slimming World

EXCLUSIVE OFFER FOR NEW MEMBERS

CHANCELLOR'S ACCUSED OF BEING FISCAL CLOWN

WOES AT WEMBLEY

Fascinating facts about POOP

JABS ARE THE DOC'S BOTOX

Honey, I shrunk the quids

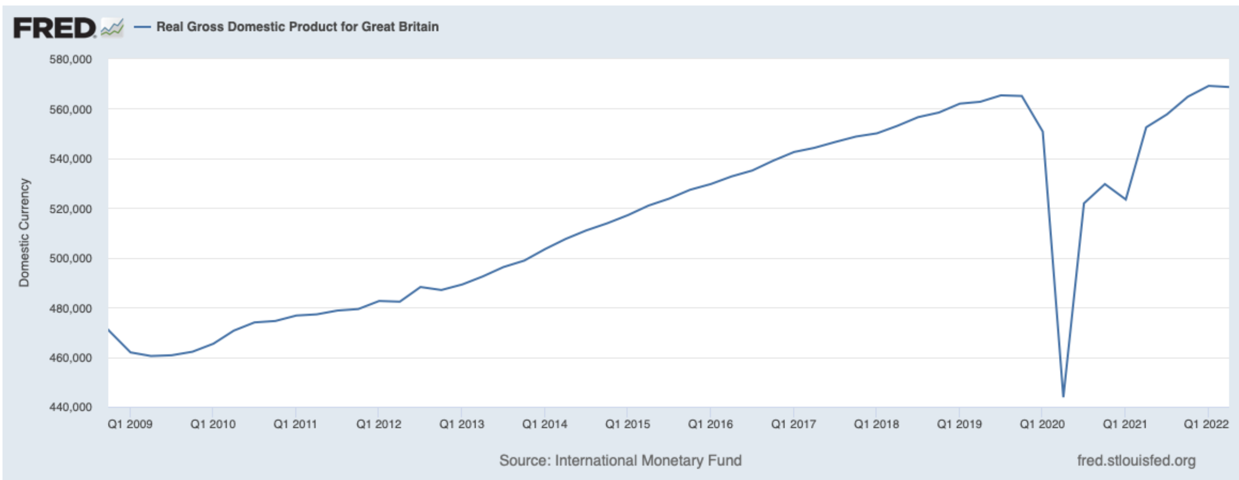
Pound hits record low and interest rate likely to rise

Experts queue up to attack Kwasi's 'A-level economics'

All these factors make it almost intuitive that the GBP would be weak, by which I mean not highly desired by investors and savers. This UK tabloid headline sums it up and indicates the general population is wise to the inflation and the lousy exchange rate. So working people are now as concerned about inflation and exchange rates as about football and other juicy tabloid stories. The GBP seems to buy less every day; everyone knows it, so who wants to hold it? And you cannot invest it profitably in either bonds or stocks. Why would you want it at all unless you have to have some to live in the UK?

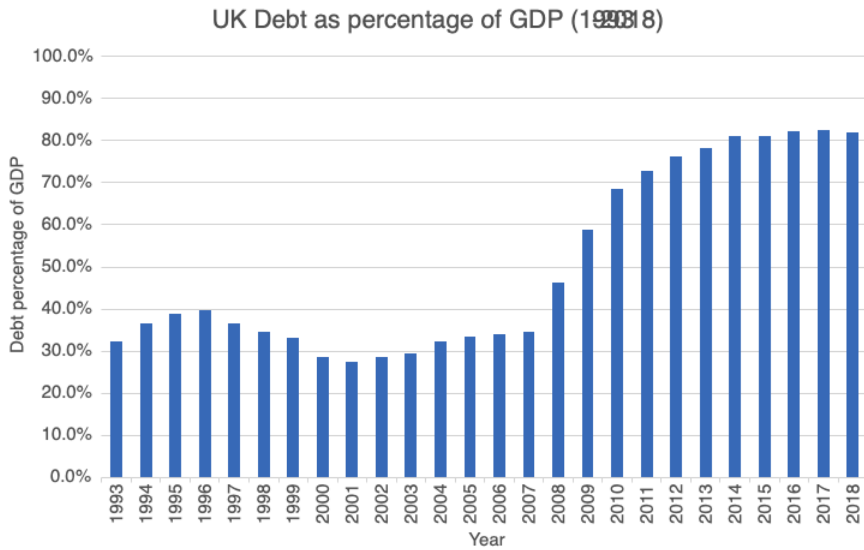
So the GBP is unpopular, mostly due to these low interest rates and rising consumer prices (what most people call inflation). So next question, what caused these low interest rates and higher consumer prices?

You know my answer if you have been to any of my talks or read any of my essays. High prices and low interest rates are mostly about excess money production. This is a graph of broad money growth in the UK from 2010 to the present. During the last two years, the UK money supply rose about 23% - not as bad as the USA, which was up almost 40%, but bad enough. Most of this money growth was due to QE by the Bank of England, some of which was used to fund government deficits and some to fund direct Pandemic relief payments from the government to consumers and businesses. Some of it also came from bank lending in the form of forgivable loans guaranteed by the UK government. It is all very similar to what happened in the USA. In both cases, I am speaking of unproductive money creation, which is inflationary.



Rising UK consumer prices are not, as some claim, primarily because of a shortage of goods, caused by supply chain problems or pandemic lockdowns. Here is a graph of real GDP in the UK, which measures the real consumption of goods and services, i.e., spending on goods and services adjusted for consumer price increases. So it is a reflection of real stuff, not prices. Although it's not impressive, the data does show real growth. Very simply, to state the obvious, if prices were higher because of fewer goods available for sale, you would have to see fewer goods consumed, that is lower real GDP! So based on this data, you cannot claim higher consumer prices were due to shortages of goods.

But higher consumer prices are consistent with higher demand caused by too much money creation. Where did the new money come from? Same place it came from in the USA: the banking system, where all money is created.

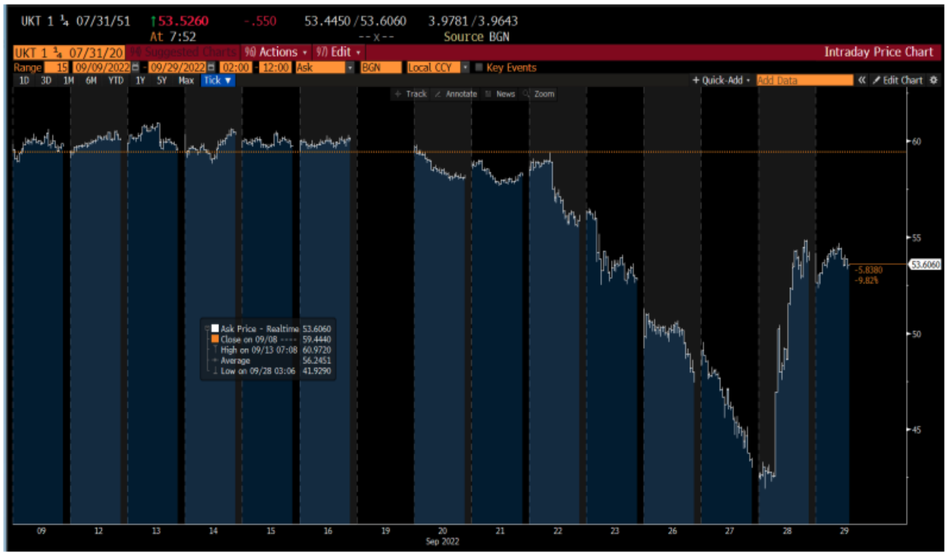


Let’s look at UK government debt. This chart shows UK government debt as a percentage of GDP. Since the GFC, UK debt has soared like many other countries. Debt to GDP went from 40% to over 100%, so a lot of additional debt was issued. About a third of the additional debt since 2009 was purchased by the BOE, the UK central bank, under their QE program, and as we know, QE bond purchases increases bond prices, driving down interest rates, while simultaneously creating new bank deposits. As you know, the same thing happened in the USA.

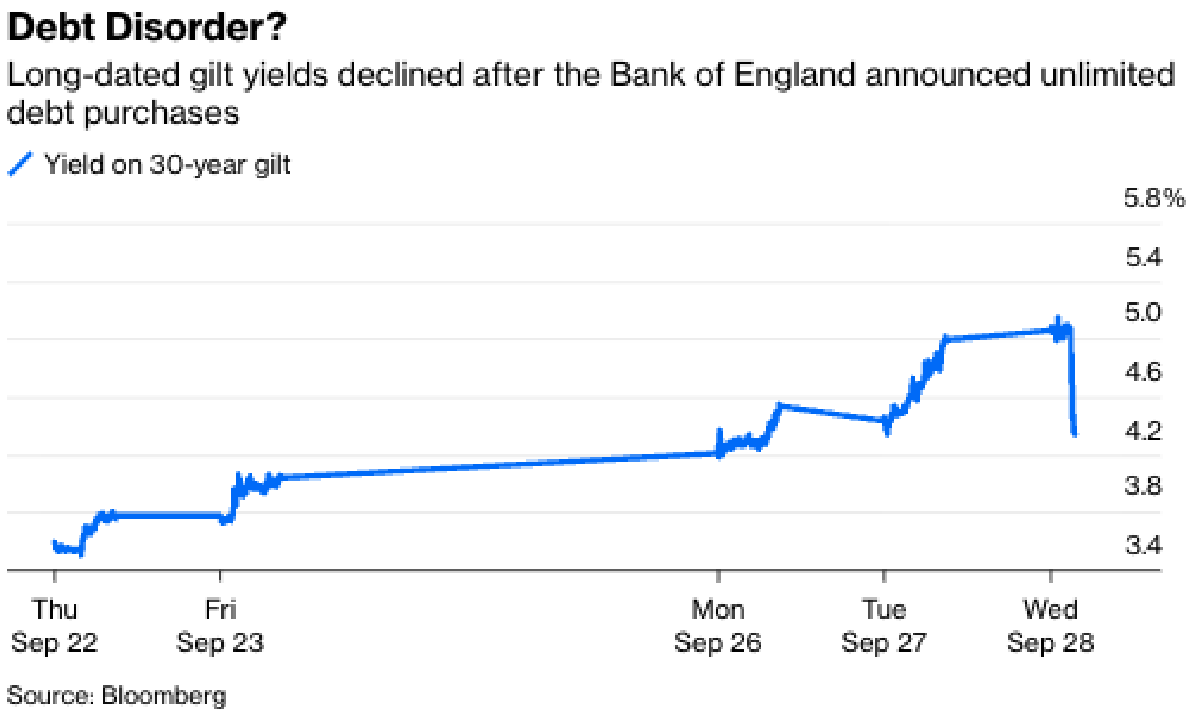
So, the major reason there’s too much money and abnormally low interest rates is that the BOE has caused it to happen with Quantitative Easing, which is pure inflation. By inflation, I mean additional money supply with mostly unproductive uses.

So let’s pause and summarize. UK economic growth is crippled, characterized by restrictive energy policy and wasteful investment in renewables, funded at least in part by QE. This was central planning that did not produce enough goods to meet the increased demand that was caused by excessive money production. So the UK's cost of living is soaring due to too much money chasing insufficient goods. Most of this excess money was first employed by purchasing government bonds, driving down interest rates, making personal savings impossible, but the low interest rates kept the the cost of funding the government abnormally low. Investment opportunities are poor for various reasons related to low interest rates and restrictive government policies. Bonds give no return, the equity market is lousy, and now consumer prices are running away. So now, the UK central bank, like the Fed, is tightening to fight inflation, so interest rates (especially short term) are beginning to rise.

All that was the backdrop to the September 26 mini-crisis. Now, before I reveal the financial institution that was at the center of this crisis, let’s pause for a question or a comment.



Let’s go back to this hard-to-read graph that covers 20 trading days in September. Around mid-September, the price of the 30-year gilt began to fall hard, day by day, in response to a new economic plan announced by the new Prime Minister, Liz Truss. Her economic plan consisted of re-opening fracking for oil and gas (excellent!), lower taxes (maybe OK), and more borrowing (not excellent!) to fund more stimulus spending designed to kick-start business activity. The market apparently saw Truss’s plan as inflationary and the need for increased government borrowing as contributing to higher interest rates, which put downward pressure on the bond market. (remember, when interest rates go up, bond prices go down) Interest rates were already rising due to BOE’s tightening policies. Then on Sep 26, in a final revolt against Truss’s plan, almost all buyers of the 30-year gilt disappeared. Liz Truss’s politics took the blame, but the bond market was already fragile, as we have seen.



This chart shows the evolution of interest rates in the days just before Sept 27. Yields on the 30-year Gilt spiked up and were headed to 7-8% by some accounts. That's a big move from 1% just one year earlier. By September 27, there were virtually no more buyers of gilts except at much higher interest rates.

As yields were spiking up around 4 to 5%, BOE suddenly announced there was big stress, a crisis of liquidity (which means no buyers of bonds), and that BOE was ready to buy lots of Gilts (60 billion). This kind of thing always means someone in the system is in trouble and is about to fail. Price moves alone will usually not cause the central bank to intervene. But if some important financial player, like a giant hedge fund or a bank, looks like they are about to fail, the central bank will step in to avoid a systemic failure. In past crises, these failures have been a hedge funds, investment banks, or commercial banks

OK, so where was the crisis? Drum roll.

It turns out, something was rotten in the UK pension system, of all places. UK private pensions are a mainstay of UK retirement. Private companies fund pensions out of their earnings. UK pension funds are big buyers of the 30-year gilt. Why? Because they have to invest today for a very long-term payout. They need a lot of 30-year bonds because they must guarantee payments over a long time frame.

So, UK pension funds are big buyers of 30 gilts because they have to have long-dated bonds, but UK pension funds also have actuarial rates of return to meet. Typically a pension fund has to earn 7-8% annually to meet its recipients' payout schedule. 30-year bonds (in a portfolio with other investments) are needed to fund a long-term obligation safely.

But BoE had pushed rates down so low it's impossible to earn that rate. There is no longer a safe 7 or 8% return out there. I wrote about this last year: it is just impossible to save for the future when central banks push rates so low, and this applies to pension plans as well as individuals.

So pension funds have to reach for yield. You cannot accrue at 7% with a 1.5% bond yield and a stagnant stock market. Therefore in the era of low-interest rates, UK pension funds have used leverage to juice their earnings. How can they do that?

By taking unprecedented risks (with the permission of the UK pension authorities). For several years, UK pension managers have been using a yield-enhancing strategy called Liability Driven Investment, or LDI. LDI is complicated, involving swaps of income streams between owners of variable-rate bonds and fixed-rate bonds, so we won't get into the details. Still, I want to illustrate how using this kind of leverage gets you into trouble when you don't assess the risks properly.

NO LEVERAGE		WITH LEVERAGE (BORROW 4000)		S-T INTEREST RATES RISE	
Bonds owned	1000	Bonds owned	5000	Bonds owned	5000
Interest earned at 2%	20	Interest earned at 2%	100	Interest earned at 2%	100
Interest expense	0	interest expense at 1%	-40	Interest expense at 3%	-120
Income	20	Income	60	Income	-20
Market value of bonds	1000	market value of bonds	5000	market value of bonds	4000
debt	0	debt	4000	debt	4000
net worth	1000	net worth	1000	net worth	0

Here are three scenarios, going from left to right. First, say you own 1000 of long-term bonds (gilts, whatever) paying a 2% interest rate. Your annual income is 2% x 1000 or $20. Over the lifetime of the bond, this 2% rate is locked in.

But you need to juice your returns. Look at the middle box. Suppose you can borrow short-term money at 1%. By “short-term,” we mean your cost to borrow can change, perhaps month-to-month, depending on conditions in the bond market. But you are betting it will remain stable. So you borrow 4000 at 1% and buy 4000 more long-term bonds yielding 2%. Your total bonds are now 5000. Your annual income is 5000 x 2% or 100. Your interest cost is 4000 x 1% or 40. Your net income is 100-40 or 60. The net worth of your investment position is still 1000, on which you are earning not 2% but 6%. Yay! This is how you plan to pay your pensioners.

The lender (likely a bank) is willing to lend to you because your long-term bonds are good collateral against your risk of not repaying the loan. If you do not pay interest, or if the value of your bonds starts to go down, the lender can legally take your bonds as payment. All 5000 of them if necessary.

So now, what happens if short-term interest rates unexpectedly rise to 3%? That’s the box on the right. Your income is still 100, but your interest expense is 120 (4000 x 3%). You are underwater, losing income. Moreover, when short-term rates rise, long-term rates also increase, so the value of your bonds (assets) declines while the value of your liabilities remains the same. Your net worth is wiped out, and if the lender calls your bonds (his collateral), you lose your entire investment.

This is known as a “margin call.” Margin calls are the death of many leveraged investors, and this in pattern was what happened on September 26 and 27. Short-term rates were up, long-term rates were rising, the value of the collateral (market value of long-dated gilts) was falling, and the pension funds were about to get their bonds taken away from them by the short-term lenders.

That’s why the Bank of England stepped in to prop up the price of the 30-year gilt.

It's just like having a variable rate mortgage on your house, which I think is normal in the UK. This seems great because you can own a 300k GBP house with only, say 100k of equity, and maybe you are paying a low variable interest rate on the remaining 200K. This is called leverage. Suppose your income is just enough to buy all the things you need to live and still pay 3% interest on mortgage. But if your borrowing rate rises to 4%, your mortgage service costs will eat up more of your income, so maybe you can no longer afford to buy gas, and at 5% you can no longer afford groceries. You would have to give back the collateral, your house, to the lender, which is your bank. This is the same thing as a margin call, it is what happened to the UK pension funds that use this so-called LDI strategy.

I might add, I suspect many of these UK pension plans are run by people who don't really know what they are doing, who took on this leverage, never dreaming bond prices and interest rates could move so far and so fast. Most of these managers have never seen inflation and have never seen sovereign bond yields above about 4 or 5%. And so you have to ask, is this a pension fund, which is supposed to be conservative, or a pension fund that thinks it's a hedge fund and makes risky investments? Leverage is at the root of nearly all financial blowups, and this one appears to be no exception.

So, the BOE had to declare an emergency and pledge to buy gilts to save the pension system. It claimed it was not buying gilts due to monetary policy but in response to an emergency. But I will point out that the emergency was caused by the very monetary policy the BOE said it was not now conducting, that is, the policy of QE (inflation) and artificially low interest rates. Before the crisis, the market for the 30-year gilt was already pretty illiquid – meaning there were not too many buyers out there at the yields offered, which means to get a trade done, the market price has to move a lot. The with the BOE not buying, there were just not many buyers left. So it looks too me like the entire crisis was set up by the previous policies of the BOE.

Then the expectation of higher interest rates and more inflation caused by the new Truss policies was the straw that broke the camel's back and kicked the 30-year gilt market into a panic. Bond prices went way down as marginal owners liquidated their 30 gilt positions. According to some accounts, the market rate was headed to 7 or 8 %. That's when BOE stepped in and pledged to buy billions in gilts, which stopped the price decline, and stabilized the market for the time being.

What would have happened if BOE had not propped up the price? Pension funds would have gotten a big, deadly margin call. They would have taken big losses on money that is set aside for retirees. The other side of the trade, the lender, wants the pension fund to pledge more cash or more gilts. But the pension funds have very little of either. Their bonds are already tied up as collateral and their meager cash is reserved for paying out current pensioners.

So if BOE had not stepped in, you'd have pension funds legally insolvent, unable to make contractual payments. This is unheard of. It's a pension fund!

If the pension funds fail, then here come the mobs with the pitchforks, understandably. Pension failures on a mass scale is the stuff political uprisings are made of. Unrest, loss of confidence, and a major financial crash as people sell everything to get to the safety of cash. So the knock-on effects could have been serious, and the BoE knows it.

And just think what this dilemma signals for the UK government. There were no buyers of UK govt debt at very low interest rates. There were only buyers at much higher interest rates. Debt to GDP is already over 100% in the UK. Interest on sovereign debt is about 3% of GDP and something like 8% of tax revenues. If interest rates go too high, interest payments could easily eat up most of the tax revenue, leaving little or no revenue to pay for all kinds of government programs, entitlement payments, defense, public works, etc. Who (besides the BoE) will buy government debt when the inflation rate is way above the interest rate? Who will fund the government? So the government is running out of ideas. This is why governments are keen to decrease the CPI inflation rate.

So the BOE, instead of continuing to fight inflation with tighter monetary policy, has had to kick the can down the road once again by pledging more QE to hold up bond prices. They are hoping they can eventually resume their tight money policy to slow down inflation. But I suspect this is only one of many similar financial stresses we are going to see in the world financial system.

I will add the UK is not alone. The USA is not exempt from this problem. Because the USA issues the world's reserve currency, many institutions and other countries have been willing to buy US Treasury bonds at low rates. The strong dollar has helped the USA, and helped our Treasury bond market because these institutions and nations need to buy some kind of investment denominated in US dollars, the world's foremost reserve currency, and the best way to do that is to buy Treasuries. But this privilege of the USA is not unlimited. Sooner or later, unless the US government reigns in its spending, we will run out of Treasury buyers at low rates just like the UK did. And when the interest rates go way up, interest costs will threaten to eat up our national budget.

So the UK pension dust-up is a canary in the coal mine. I very much suspect we are headed for another more significant liquidity event, maybe a sovereign debt crisis or something that looks like it. Where the next crack will appear is hard to predict.

The UK event reminds us of the consequences of excess money creation. The weak currency, super low interest rates, excess money production, pension fund risk, loss of confidence in the bond market – all of this was precipitated by the UK's unsound monetary policy. We as citizens need to learn from it.

Now I want to say a brief word about owning gold. We live in inflationary times, and gold is supposed to be a hedge against inflation, but it has not performed too well lately n terms of its dollar price. But this is partly because of the extraordinary strength of the dollar and the weakness of other currencies. In terms of other currencies, gold has done its job fairly well.

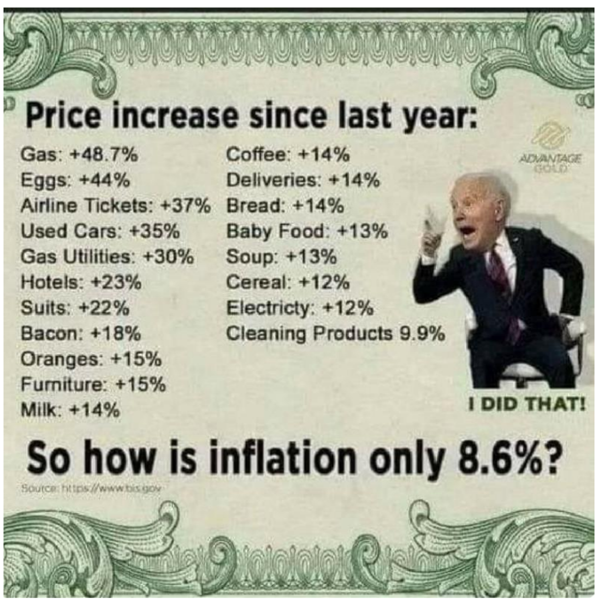
Here is a long term chart of gold US dollars per ounce. Note at the far right, the price went from about 2000 to about 1730 today, a decline of about 15%, even though CPI inflation has gotten worse.

But now here is a chart of gold in GPP per ounce. Notice the far right price has stayed right up near its all-time high.

Also notice on both of these charts, previously the gold price peaked at the height of worldwide financial stress, around 2011 and 2012. This was in the aftermath of the great crash, of 2008, and notice that during that crash, gold rose as the financial stresses rose.

So I suspect (I do not know) that if we have another major financial accident in the future, we have a good chance of seeing gold do its traditional job as a safe-haven asset that maintains liquid real cash value. So I do own gold and will continue to do so.

Jim Grant of *Grants Interest Rate Observer* says the price of gold is the reciprocal of the level of confidence in central banks. As that confidence in central banks declines, I expect the gold price to rise.



BONE PILE:

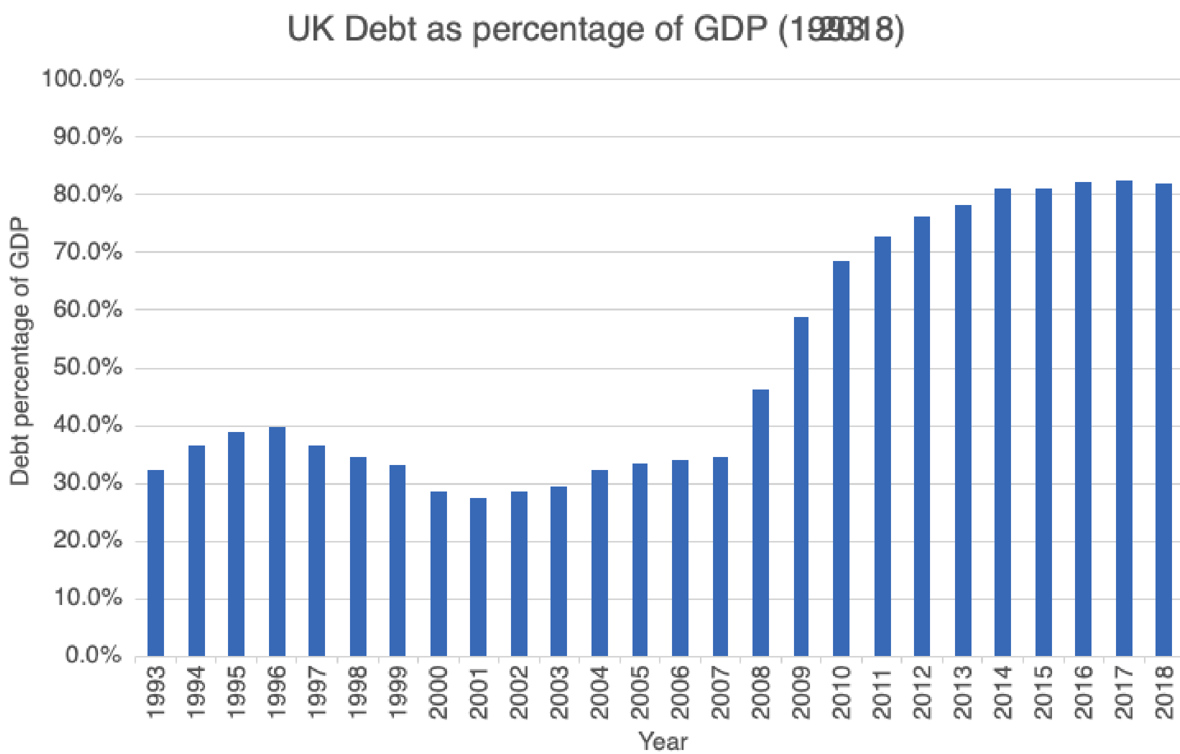
Who is on the other side of this LDI trade?

Whoever is lending the money is worried they would not get their collateral back. That brings their financial stability into doubt as well. Is it Credit Suisse and Deutsche Bank? There are rumors, and here are their stock prices. I don't know; this is pure conjecture.

Now finally as a bonus let's look at one possible hedge against a poor investment environment, CPI price rises, low interest rates (inability to save) and malfeasance by central banks. Gold has been called the reciprocal of faith in central banks. And radical monetary policy begets radical monetary policy. Recently, despite high CPI inflation, gold has not done too well if you price it in dollars. It looks much better against the currencies that have done poorly against the dollar chart]
So I expect when and if the dollar declines or stops appreciating against other currencies, gold priced in dollars will do a little better. I am a long-term gold owner, and in times like these, I have some confidence it will help hold up the value of your portfolio.

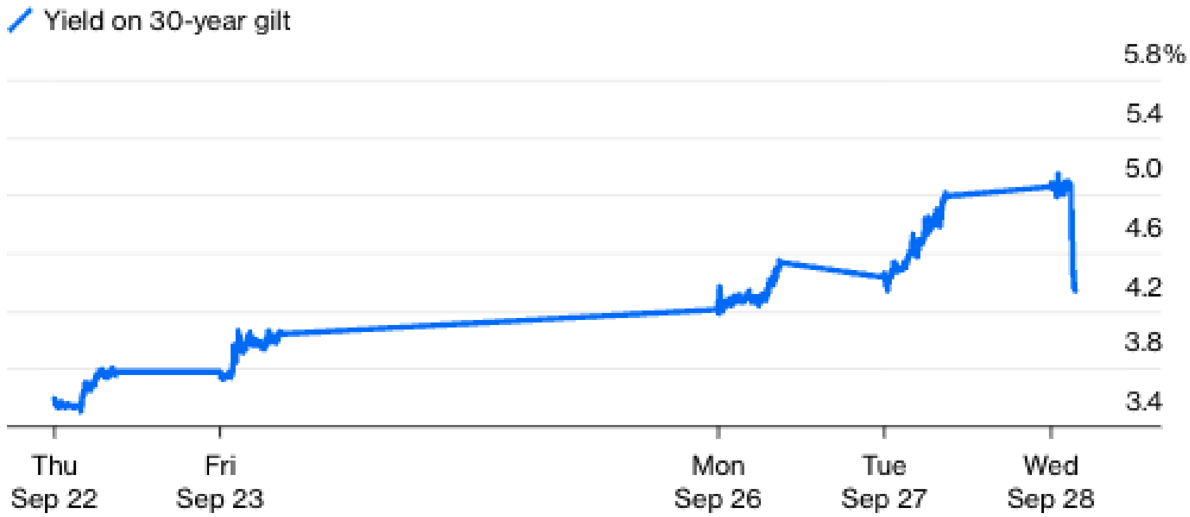
If interest rates on a 30-year bond go from 1.5 to 4.0 to 8.0 the value goes down very steeply
Why would the value of the bond go down so much? Because of fear that rates will rise with rising inflation.
So when Truss et all announced they will lower taxes, spend more, etc, that looks inflationary
Therefore buyers of British gilts evaporate. There already were not very many
And other marginal hollders want to sell at almost any price
The pension funds have not enough cash
The only solution is to get the price of the 30 gilt up so pension funds will not lose their bonds
And who is the only entity that can do that? The Bank of England
So BOE bought bonds big time and started QE in England all over again.
But this was the reason for the inflation in the first place.

So it seems there is no place to go. And Truss is getting the blame. And had to back down on her plan.

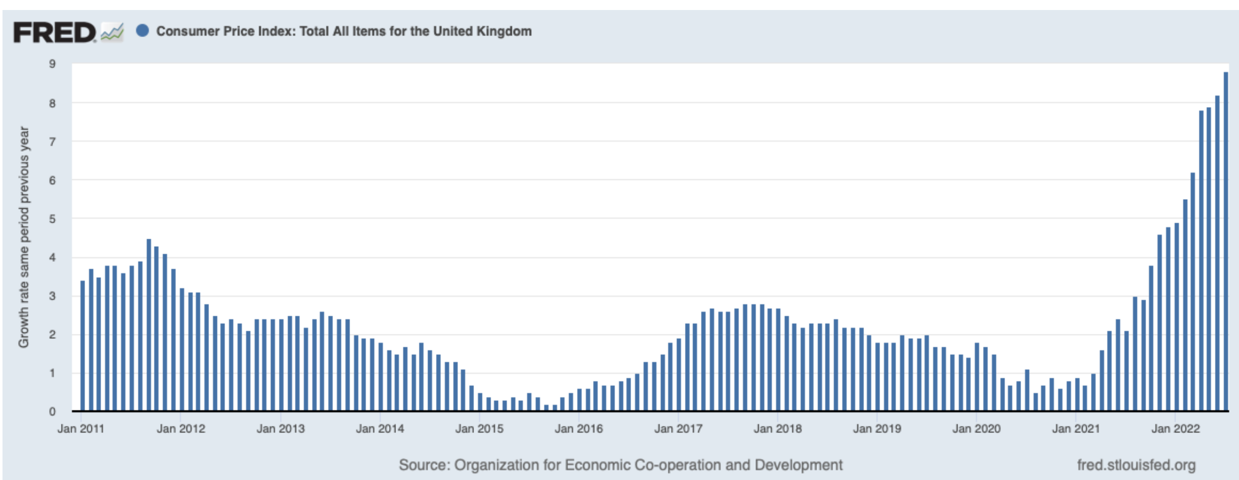


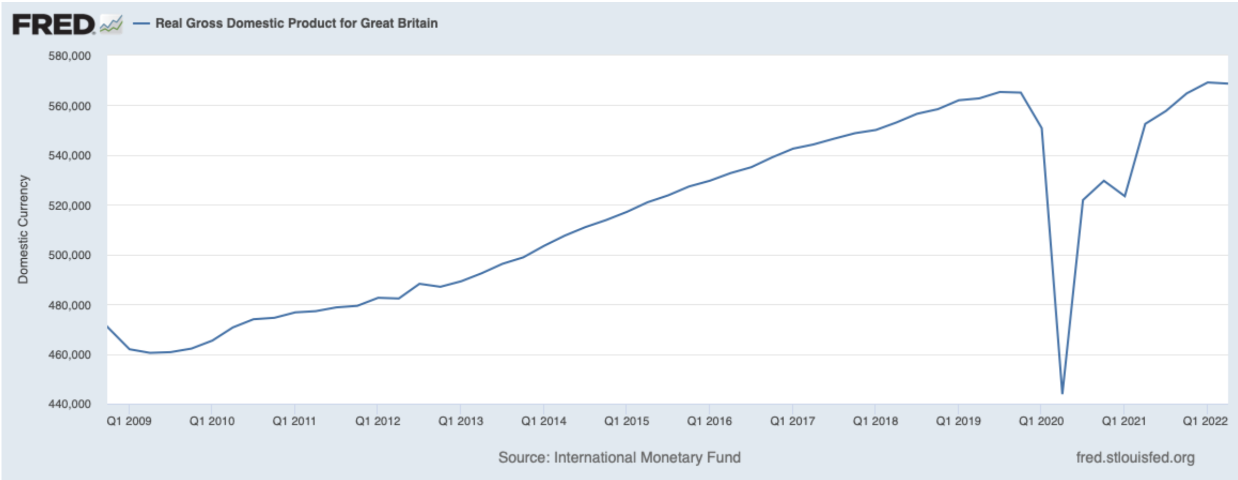
Debt Disorder?

Long-dated gilt yields declined after the Bank of England announced unlimited debt purchases



Source: Bloomberg




FRED
Real Gross Domestic Product for Great Britain
Domestic Currency
580,000
560,000
540,000
520,000
500,000
480,000
460,000
440,000
Q1 2009
Q1 2010
Q1 2011
Q1 2012
Q1 2013
Q1 2014
Q1 2015
Q1 2016
Q1 2017
Q1 2018
Q1 2019
Q1 2020
Q1 2021
Q1 2022
Source: International Monetary Fund
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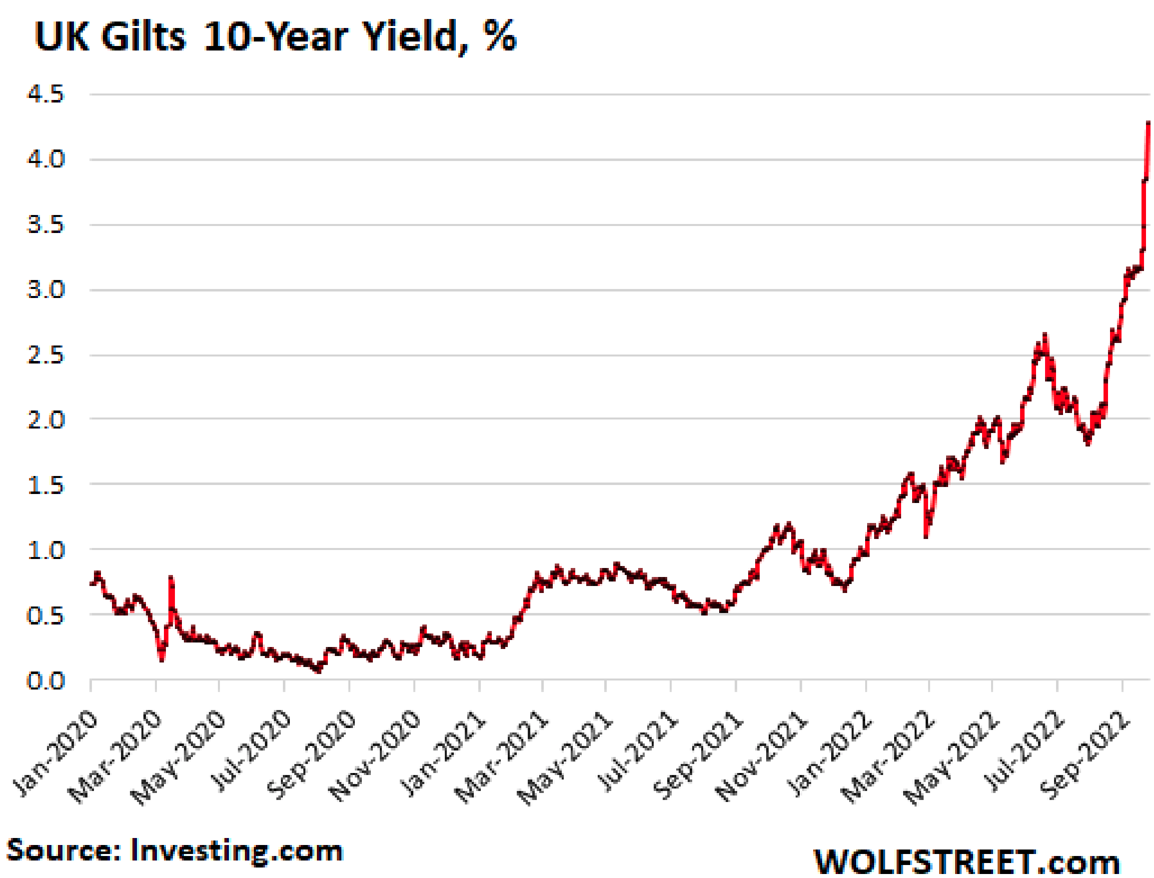
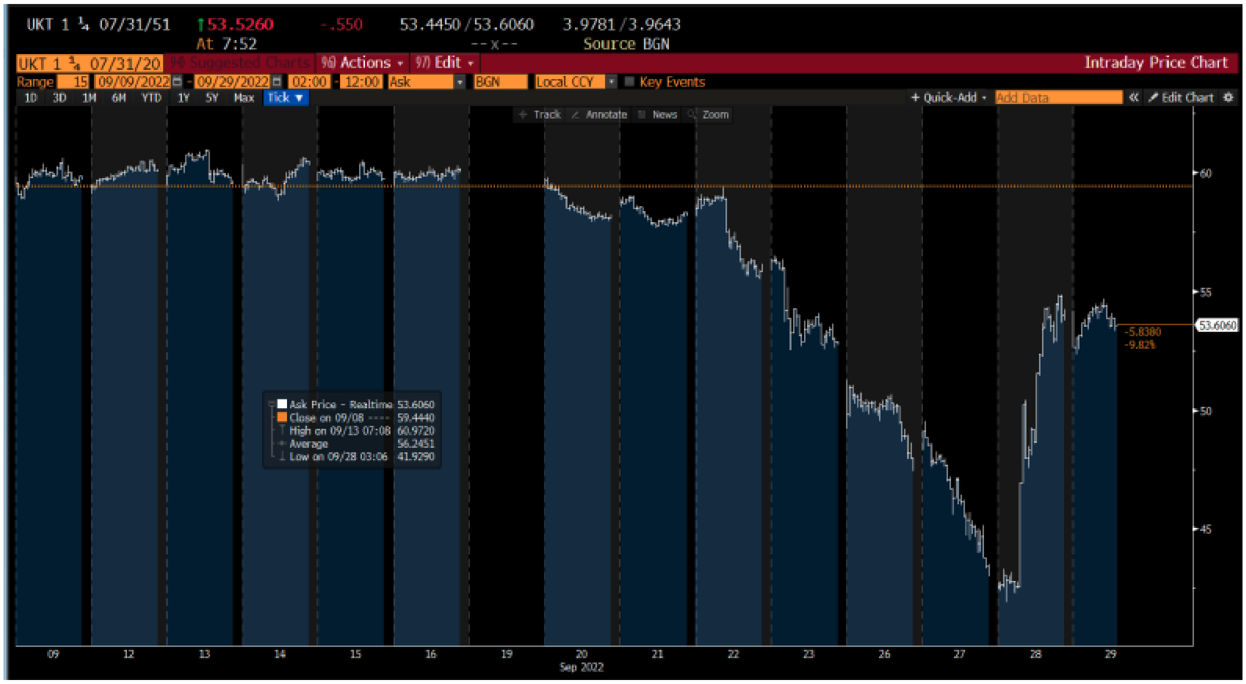
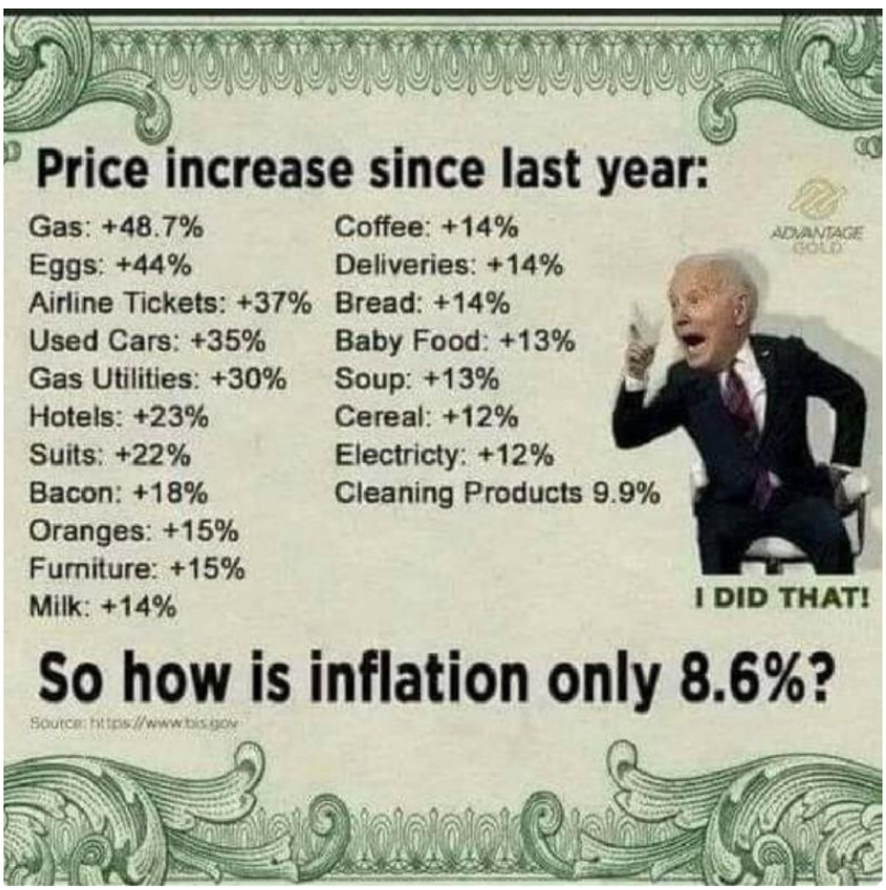
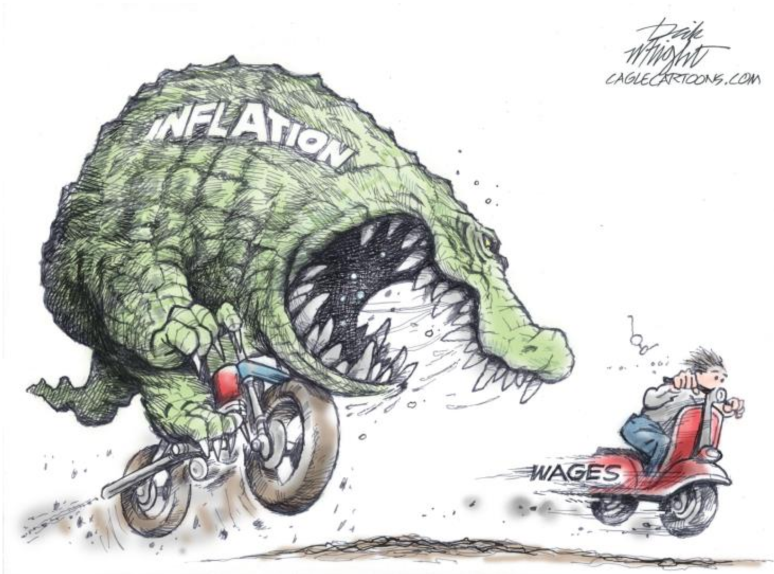

UK Gilts 10-Year Yield, %
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
Jan-2020
Mar-2020
May-2020
Jul-2020
Sep-2020
Nov-2020
Jan-2021
Mar-2021
May-2021
Jul-2021
Sep-2021
Nov-2021
Jan-2022
Mar-2022
May-2022
Jul-2022
Sep-2022
Source: Investing.com
WOLFSTREET.com


UKT 1 ¼ 07/31/51 ↑53.5260 -.550 53.4450/53.6060 3.9781/3.9643
At 7:52 Source BGN
Intraday Price Chart
Ask Price - Realtime 53.6060
Close on 09/08 59.4440
High on 09/13 07:08 60.9720
Average 56.2451
Low on 09/28 03:06 41.9290
Sep 2022


Price increase since last year:
Gas: +48.7%
Eggs: +44%
Airline Tickets: +37%
Used Cars: +35%
Gas Utilities: +30%
Hotels: +23%
Suits: +22%
Bacon: +18%
Oranges: +15%
Furniture: +15%
Milk: +14%
Coffee: +14%
Deliveries: +14%
Bread: +14%
Baby Food: +13%
Soup: +13%
Cereal: +12%
Electricty: +12%
Cleaning Products 9.9%
I DID THAT!
So how is inflation only 8.6%?



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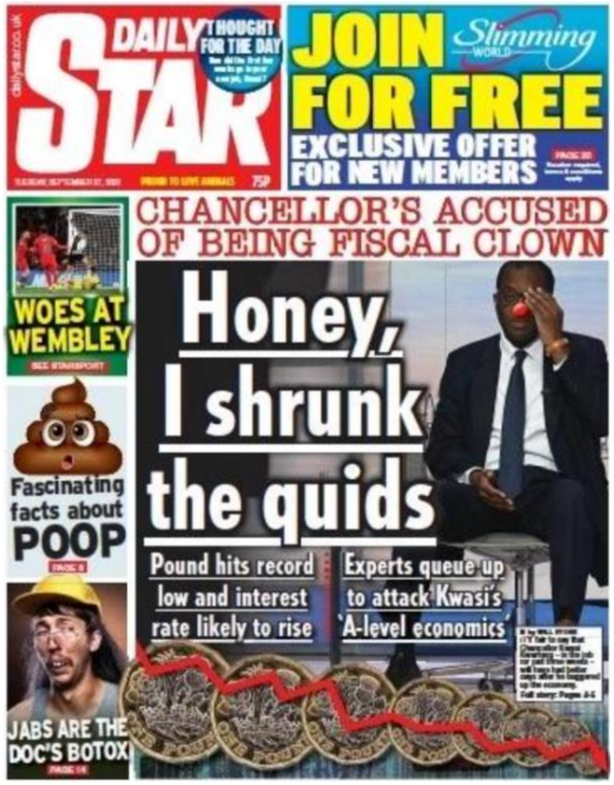

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