Eyes Wide Shut

HINDE CAPITAL

Part I. The UK Hitting the Wall



"Much has been written about panics and manias... but one thing is certain that at particular times a great deal of stupid people have a great deal of stupid money".

Walter Bagehot, 'Essay on Edward Gibbon'

Part I. The UK Hitting the Wall

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AN OLYMPIC HANDOVER

“Buck up, bitter Britain and break out the bunting”. This was the title of a recent Sunday Times article by a journalist, India Knight. The gist of the piece was that the default position for most of us in the UK is cynicism. She wants us all to embrace the positive and undertake serial amounts of enthusiasm. We must be thankful for what we have. Sure we may have a lot to celebrate this year. Even if you don’t like your sport, the British Olympics could serve to reignite pride in a nation. Our collective morale has been dented by the despair we feel at a listless economy weighed down by too much debt.

However the alacrity by which we British tend to embrace cynicism is for many a coping mechanism often dolloped with generous portions of hilarity - thankfully so in our opinion - a throwback to British trench warfare humour. Men such as Captain Alexander Stewart epitomised this only too well. He wryly noted in his memoirs the annoyance at the interruption to his smoking on the unexpected visit of a German soldier; he had to shoot him. He later suffered severe post-traumatic stress. Today we may not be in the trenches of yesterday years, but society feels precarious. Perhaps if this current generation were to witness such whole-scale atrocities of the WWI and II, god forbid, we British may be more thankful. But everything is relative.

The British psychologist Oliver James wrote a book some decade ago called ‘Britain on the Couch’ - the low serotonin society. He depicted that the way we live now, rather than our genes, induces in our bodies low levels of the ‘happiness brain chemical’ serotonin. We lead such fast and furious lives and in our attempt to ‘keep up with the Joneses’ we have strived too much for material success. The cost; longer work hours, less organic happiness and a depressed psyche. He asks the question, why when we live in a period of unprecedented affluence are people so seemingly more unhappy than before. Oliver has a point. Standards of living are much higher today than they were, but he also misses the crucial point of what affluence is - what is wealth and money? If you recall, we explored these concepts in last month’s letter ‘The Wealth of a Nation’, and will touch on the key points we made below.



Source: Olympic Flame and British God, David Beckham, (and Vestal Virgins), AP



Money is considered by many as 'wealth'. It is not. It is a store of wealth, which is also a way for society to measure and transfer the true ownership of wealth from one entity to another. It is an amorphous claim on wealth. Wealth has grown globally this past decade, as borne out of an illusionary monetary system that has utilised 'cheap credit' to underpin asset prices. This pernicious and self-perpetuating credit based system has created wealth in the UK, which as we will show is totally unsustainable. Far from needing boosts of serotonin and cynicism, what Ms Knight and Mr James miss is what we really need, and that is a healthy dose of reality.

We can't help but feel that the handing over of the Olympic torch in Greece to Britain recently by eleven Vestal Virgins no less, was more symbolic of the passing over of burning economic woes from one ruined nation to another, than it was of commemorating the theft of the continuous Olympic flame from the Greek god Zeus by Prometheus. **We wish it were not, but we cannot stand by and walk with our Eyes Wide Shut, as many citizens, perhaps, understandably do today.** It is our fiduciary responsibility both as an investment management firm to protect our client's wealth whilst it is our right as free citizens to create a discourse on how we maintain a free economy and society.

We wish to outline the gravity of the situation in which the UK finds itself, and by assessing how we got here we can begin to offer our solutions both for monetary and political reforms. Unfortunately we are deeply concerned that far from being cynics or purveyors of doom, the very harsh reality is that the UK is caught in an intractable spiral of negative outcomes. There are no good choices just bad or worse choices. It is going to take a herculean effort to transport ourselves from the right 'sterling mess' we find ourselves in today. It will take a deep change of psyche of the entire nation to effect it. We don't think a few gold medals will do it, although their 'melt value' could restore the Treasury's dwindling coffers. Sorry, there goes that cynicism again. Stein's law of 'hitting the wall' feels to be an appropriate metaphor for the parlous state of UK finances and our ability and propensity to borrow to spend.

HITTING THE WALL

- There are no signs the UK is on the mend. The UK debt profile both in the public and private sector is continuing to grow as a share of GDP. Although this is not uncommon in the aftermath of banking crises this has gone on for a period atypical of past crises.

- Growth is worryingly absent and so the UK has structural tax problems. As each year passes not only does the cyclical fiscal deficit grow worse but the structural primary deficit threatens to rise exponentially. Public sector finances are not rebalancing. In fact, as we will show the public sector net borrowing requirement (PSNBR) is continuing to grow despite the Coalition government's promises of austerity.

- Historically, countries with such high indebtedness as the UK have been associated with a rising incidence of default, or even restructuring of debt. However, a more subtle means of maintaining the 'debt affordability' is through a form of debt restructuring called financial repression whereby a central bank maintains rates below the natural market rate and performs purchases of government debt – quantitative easing (QE).

- The BoE bond purchases serve two purposes. First, it enables the fiscal gap to be plugged and, two, because its purchases prevent bond yields rising, it enables the UK government to service its growing debt at lower, more manageable nominal rates whilst the incidence of negative real rates erodes the real value of government debt.

- The impact of lower rates from QE creates many distortions in the economic and financial structure. Company pension funds must discount future liabilities at a lower rate, driving deficits higher. Company actuaries demand more bonds to cover the higher liabilities.

- These low rates have also masked the extent of UK problems as they have forestalled consumer deleveraging which is essential if the economy is ever to grow productively absent of debt burdens. Lower rates have similarly postponed the risk of mortgage and consumer loan delinquencies, as they remain serviceable so bank balance sheets have not de-levered suspect assets, which appear solvent.

- The irony is that cheaper credit has not encouraged loan demand as household debt has no room to grow. The pressure from regulators to provide more reserves on their balance sheets as helped tighten bank credit conditions. The effect is a creep higher in all funding rates but particularly on standard variable rate (SVR) mortgages. With SVRs comprising almost 70% of all outstanding mortgages, this spells danger for household debt servicing.

- Higher mortgage rates are squeezing low disposable incomes still further, which will significantly impact consumer growth in the UK economy. Aggregate demand will fall as a consequence and with it government (tax) revenues will also fall, hampering the government's attempt to reduce the fiscal deficit.

- The commensurate rise in sovereign debt levels will see the UK witness the continued presence of the BoE in the gilt market but this does have important psychological limitations. Investors will become increasingly perturbed at the use of printed funds to service the UK debt situation and will want compensating with higher returns for the potential inflationary implications.

- There is an ever present and real danger that the debts of the UK will not be tolerated by financial participants. The UK faces a very significant debt issue which threatens to become a full blown sterling crisis. This is clearly not an eventuality that markets are currently assigning any probability.

- Financial markets will begin to question the sustainability of a low (no) growth economy that is highly indebted in all sectors of the economy, public and private. When this happens an economy that has external debts as high as 400% of GDP, held primarily in the financial sector, and runs a balance of payment deficit will see capital withdrawn overnight. We have witnessed this already in Spain and Italy – where bond yields rose dramatically to levels that ensure crippling debt servicing rates.

- The UK is very much as bad if not worse than the European periphery. The only difference is that the UK is not going to be choked by the rigidity of the euro. A single currency union doesn't allow countries to devalue their real effective exchange rate, unless they drop out of the currency union. The only means by which these countries can remain competitive is by undergoing an internal devaluation via a collapse in wages and drop in price of goods/services produced. This inflicts untold hardship on these countries' populations.

- The UK can undergo a devaluation as sterling is free floating. However a rapid decline or crash would be highly destabilising for the economy as rates will have to rise in bond markets to compensate holders of gilts for an inflationary tax and real capital loss.

- We believe a sterling crisis could well occur as a function of a fiscal crisis and capital will flee the gilt market, and the more capital flees the more the burden falls on the BoE to help fund the UK; but this will have a deleterious impact on the value of the currency which by now will be free-falling.

- A 'sudden stop' of capital may not fit the existing theory of currency crashes of first to third-generation models but it would not be atypical as since the end of WWII we have experienced 5 Sterling crises: 1947, 1967, 1976, 1992 and 2008/09, on average every 15 years.

- The 2008/09 although experiencing a 25% decline was largely due to the demand for dollars from the debt deflation swept the globe and impacted all currency pairs to the dollar. This next sterling crisis will be that of sterling itself. **No nation needs to own sterling** and with excessive global sovereign debt nations are crowding each other out. Overseas creditors will be less forthcoming and turn inward to meet their own domestic financing needs.

In a world of turbulence the UK currency and its bonds have benefited from the best of a bad bunch approach and in a financial system so heavily financed by the bank and pension industry, such entities have little alternatives or often choice but to maintain bond holdings of nations. Given the choice of Greek government debt or gilts the immediate choice is easy. But the domino effect of collapsing fiscal balances will leave fewer and fewer so called safe havens.

STOP GO ECONOMICS?

"I can report that since 1997 Britain has sustained growth not just through one economic cycle but through two economic cycles, without suffering the old British disease of stop go - with overall growth since 2000 almost twice that of Europe and higher than that of the United States."

Gordon Brown, then Chancellor of the Exchequer, Budget 2004

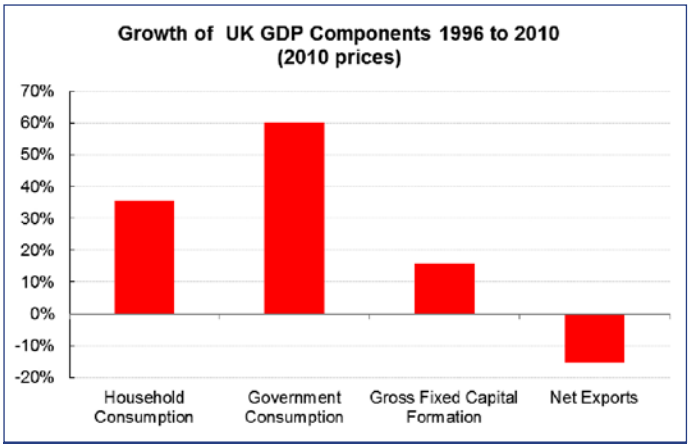
NO GROWTH, MORE DEBT

There was an overwhelming sense at the time, from 2000 to 2007, that Gordon Brown was a great and prudent Chancellor. He wasn't. Clearly the question will remain; would a Conservative or SDP Chancellor have done any better? For us it's not relevant for the framework of this letter other than we need to diagnose the problems that arose under his guardianship and that which led the UK into the very real economic woes it faces today.

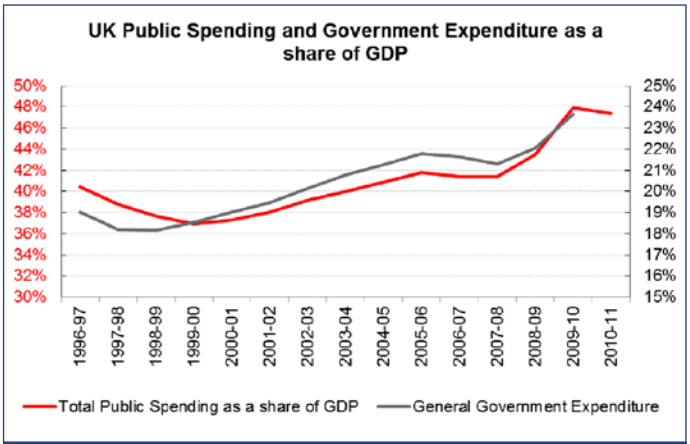
The 'naughties' was a decade of growth but this growth was not real. It was not a growth borne out of production from savings, but it was a false growth borne out of rising debt levels. The UK's seeming prosperity was and still is an illusion.

The UK experienced a credit fuelled boom predicated on escalating private sector borrowing drawn primarily out of the equity of rising house prices. The tax revenues this spawned allowed the Labour government to grow the hand of the State, leading to a now unsustainable growth in public sector debt.

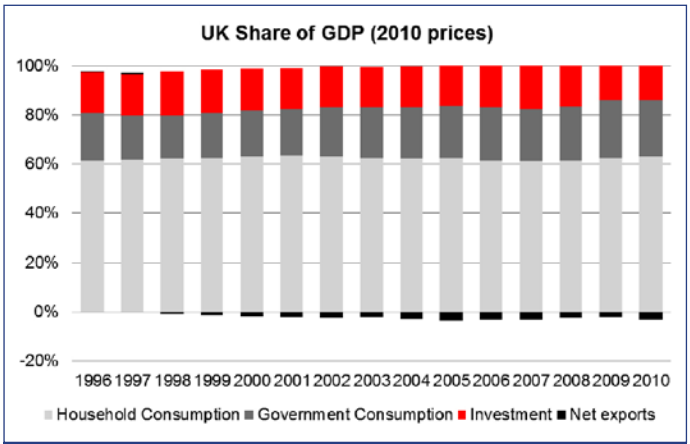
Money was not earned, it was borrowed and spent on fancy clothes, smart cars and endless electronic devices whose fads changed by the hour it would seem. The rise in public sector employment as a share of the UK economy not only helped reinforce this debt binge as this new gainfully employed enjoyed the fruits of their labour, but it no doubt did not harm New Labour's re-election potential. A prosperous electorate, after all, is a happy electorate. **Compared to the value in 1996 government consumption stood 60% higher in 2010 (constant prices) which is almost twice the increase of household consumption and about 4 times bigger than the growth rate of investment.**



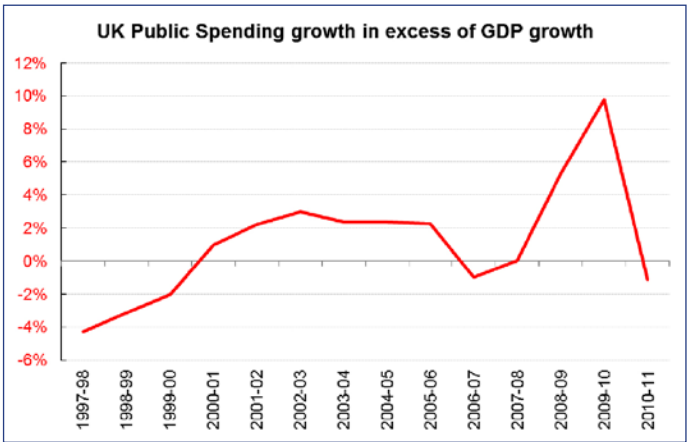
Source: ONS



Source: ONS, HM Treasury



Source: ONS; (does not add to 100% because we have omitted inventory growth)



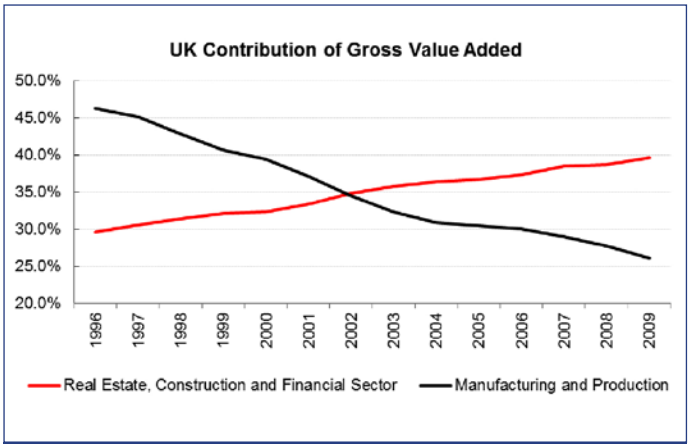
Source: ONS, HM Treasury

In 2000 government spending was £451 bn, by 2010 this was £668 bn a year. Government escalated spending in healthcare by nearly 90%, in education by over 60%, whilst the overall cost of government was 100%.

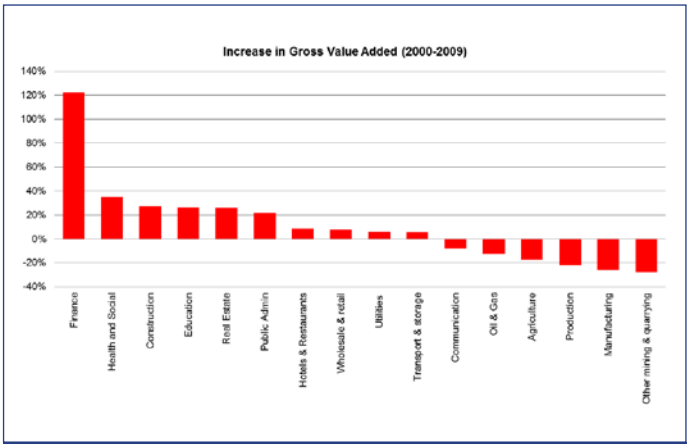
From 1996 to 2010, net exports and investments fell as a share of GDP while government consumption grew. Household consumption remained largely constant. In this sense, the UK economy has substituted net exports and investment growth for growth in government expenditure.

It is important, though, to distinguish between total public spending and final government expenditure derived from the GDP accounts. The latter makes up only goods and services purchased by the government while the former is a more precise look at structural size of the public sector of the economy.

Since 2000, growth in total public spending has persistently outstripped real GDP growth and this is not a function of automatic stabilizers in the context of the 2008/09 crisis. This was also the case during the good years.



Source: ONS, HM Treasury



Source: Tullet Prebon, ONS

THE CHANGING FACE OF THE UK ECONOMY

The UK economy has changed dramatically in the past 15 years. The best way to show this is to focus on the almost textbook crossover between the steady decline of production and manufacturing as a share of gross value added relative to the ascendency of the real estate, construction and financial services sector.

Once a nation of bustling mining and a solid manufacturing base, the UK has morphed into a society where financial engineers, estate agents and the public sector have taken over as drivers of growth.

FIRE IN THE HOLE

Brown meddled in financial tax legislation, which cost pensions dearly and aided and abetted the credit boom. He presided over the change in accounting rules that forced fund managers to provide a snapshot valuation of the market value of their assets and liabilities. The consequence was managers had to shift vast sums of money out of equities into gilts, enabling government to issue debt at increasingly attractive lower yields. The lowering of the rate structure helped fuel credit demand, which fuelled the FIRE sector.

His decision for an independent BoE, was lauded, but it was Brown who determined the inflation rate be set at 2.5%, excluding mortgage interest payments on houses. By ignoring the appreciation in the value of land and property in such a manner the BoE effectively was inured to the escalating house prices, which so determined the UK's consumption. So even as the Financial Services Authority warned of rising mortgage debt Brown et al could look blindly on, well at least out of his good eye.

Brown helped recreate a version of America's FIRE economy, whereby revenues ultimately got recycled into new lending to earn yet more interest and dividends, along with a rising flow of amortization payments to pay off the rising principal. So the volume of debt rose exponentially relative to national income and production as more and more revenue was diverted to pay interest in the financial sector. Property prices continued to rise as a function of this continued mortgage lending. All the time this diminishes the ability of the real economy to deliver capital and consumption goods. Minsky articulated this best in his book 'Stabilising an Unstable Economy', which outlined this debt dynamic in his Financial Instability Thesis:

There are three types of financing of positions in assets that can be identified in the financial structure of our system:

Hedge, speculative, and Ponzi finance. These financing regimes are characterised by different relations between cash payment commitments on debts and expected cash receipts due to the quasi-rents earned by capital assets or the debtor contractual arrangements on owned financial instruments.

Hedge financing units are those which can fulfil all of their contractual payment obligations by their cash flows: the greater the weight of equity financing in the liability structure, the greater the likelihood that the unit is a hedge financing unit.

Speculative finance units are units that can meet their payment commitments on 'income account' on their liabilities, even as they cannot repay the principal out of income cash flows. Such units need to 'roll over' their liabilities — issue new debt to meet commitments on maturing debt.

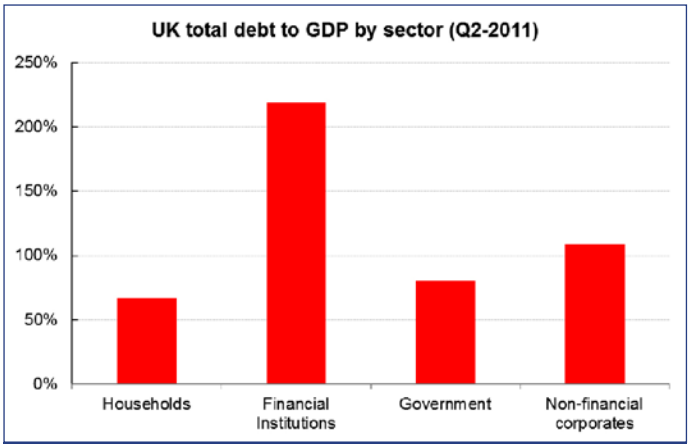
For Ponzi units, the cash flows from operations are not sufficient to fill either the repayment of principal or the interest on outstanding debts by their cash flows from operations. Such units can sell assets or borrow. Borrowing to pay interest or selling assets to pay interest (and even dividends) on common stocks lowers the equity of a unit, even as it increases liabilities and the prior commitment of future incomes.

It can be shown that if hedge financing dominates, then the economy may well be an equilibrium-seeking and containing system. In contrast, the greater the weight of speculative and Ponzi finance, the greater the likelihood that the economy is a deviation-amplifying system.

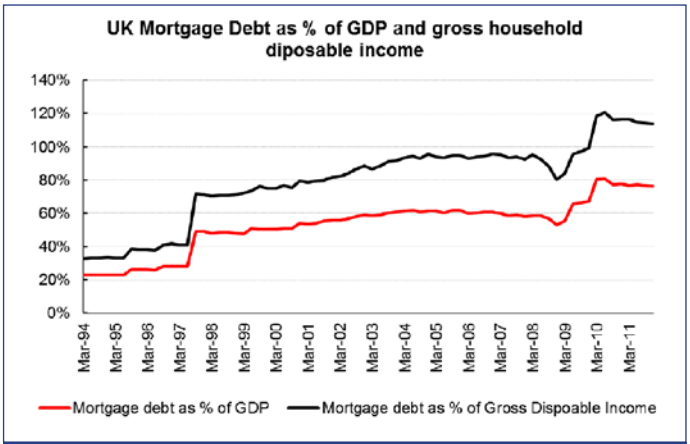
Over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system. In 12 particular, over a protracted period of good times, capitalist economies tend to move to a financial structure in which there is a large weight to units engaged in speculative and Ponzi finance.

When investors have cash flow problems due to spiralling debt they have incurred in order to finance speculative investments, a major sell-off begins…as no counterparty can be found to bid at the high asking prices previously quoted, leading to a sudden and precipitous collapse in market clearing asset prices and a sharp drop in liquidity.

(coined by some as a Minsky Moment)



Source: McKinsey, January 2012



Source: McKinsey, January 2012

So Brown encouraged a 'FIRE' economy, one based on Finance, Insurance, and Real Estate. **The growth in credit was most directed into housing which had substantial spill-over effects.** Construction, estate agencies, building suppliers, house good suppliers, plumbers, electricians, financial and legal services, they all benefited.

The chart (Increase in Gross Value Added) clearly shows that the FIRE sectors were the fastest growing sectors from 2000 to 2009. The fastest growing sectors after these were the public sector - administration and defence which grew 23%, education which rose 26% and health and social services which rose 34%.

Real GDP increased by 16%, 1999 – 2009, whilst public spending increased by 53% and public debt rose by 73% (not including financial bailouts). Household consumption grew 18% due to personal indebtedness.

The problem here is not the shift itself, but rather that the rise in credit expansion that has accompanied this shift. The UK is one of the most leveraged economies in the world, surpassed only by Japan. The total debt to GDP in the UK stood at 507% of GDP in the middle of 2011 according to figures from McKinsey.

Mortgage finance increased from £495bn to £1.2 trn (1999-2008). LTVs of 120% were common place and banks fought over themselves with very low teaser rates and even fixed mortgage rates to gain a share of the booming property market. As house prices rose, individuals borrowed on the equity of their houses. Annual equity released was some £50 bn and unsecured debt rose from £120 bn in 1999 to £230bn by 2008. Credit checks were an irrelevance - 'loan sir, how much would you like sir?' - and to be fair 'liar loans' were rife as credit standards were as slack as an incontinent's bladder.

The implications we can draw from the knowledge that growth was so heavily reliant on areas of credit and public spending (afforded by growth in debt fuelled sectors) is important. The UK has experienced debt saturation and demand for loans is not possible or should not be even desirable again. As this sector bore no growth until the UK eradicates itself of its debt burdens it will not likely experience any real growth. Without growth the UK will not be able to reduce its structural deficits other than by harmful modes which will only exacerbate and escalate the UK hitting the wall figuratively and actually. (See section on Economic Repression and Sterling Mess). One can clearly see that if almost 70% of growth was driven by debt-laden sectors, then how can the UK hope to grow in the next 5 years, or longer, until such time as its debts are written down.

We will illustrate a practical limit to how much the UK can replace private debt that spurred the economy over the last decade, and with housing affordability so low still, private debt cannot be replaced or escalated. In economic parlance we call this the law of marginal utility and, similarly, the law of diminishing returns from debt.

The arresting of this credit edifice by extremely low funding rates has merely set the fuse for the delayed detonation of our financial and economic landscape. 'FIRE in the hole' sapper. Credit has enabled a great disparity in wealth to grow in the UK, those who have and those who have not, but the destruction of debt and the assets it underpins may well help reduce this divide. Today though the UK still remains a nation divided.

A NATION DIVIDED

The country is divided both metaphorically and in actuality. The stats reveal a country short on education, a growing income inequality and apathy towards exercising its right to vote amongst the younger generation. The overwhelming issue which runs deep in the UK is the nation's collective sense of entitlement primarily nurtured by an over inclusive welfare state and easy access to credit. This sense of entitlement is exacerbated as those who have access to land and finance are enriched by the inflationary monetary system we have today. In a world of instant access and consumerism – 'if they can have it, then so can we' applies.

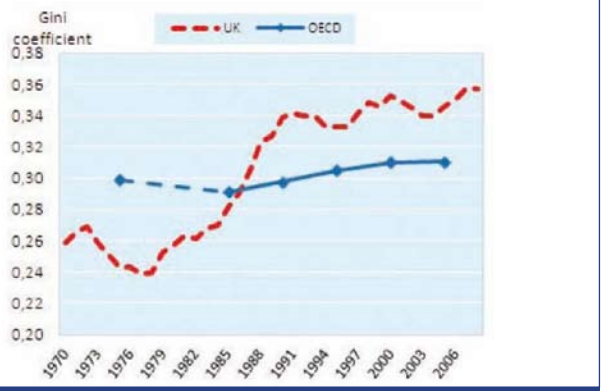
The gap between rich and poor is greater in the UK today than at any point in the last 40 years since the start of this current fiat monetary system; and the gap is greater in the UK than in three-quarters of OECD countries. Over 5 million people in the UK suffer from the multiple disadvantage of low income, poor health, no qualifications or unemployment.

Income inequality among working-age persons has risen faster in the UK than in any other OECD country since 1975. It briefly peaked in 2000 but since 2005 it is on the rise again. The average income of the top 10% in 2008 was almost £55,000, 12x higher than that of the bottom 10% who had an average income of £4,700. This is up from a ratio of 8 to 1 in 1985. Although taxes and mainly benefits have reduced this inequality by over 25% in the UK – the welfare state at work again, amen.

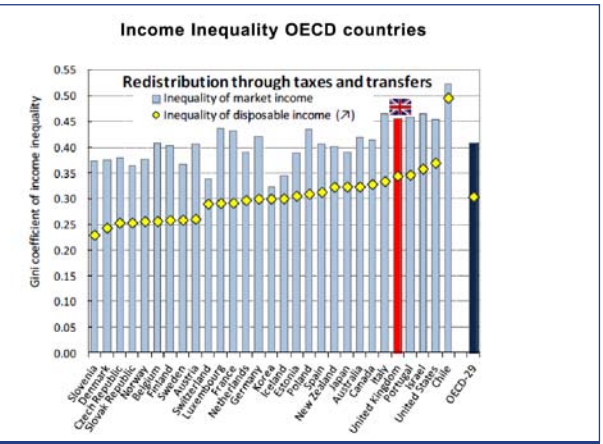
Despite this income gap we would note this. **The higher-paid worked more hours.** As in most other OECD countries, the UK recorded a trend towards an increasing divide in hours worked between higher- and lower-wage earners. Since the mid-1980s, annual hours of low-wage workers remained stable at around 1050, while those of higher-wage workers augmented from 2240 to 2450 hours. Much is made of income inequality but there is a harsh reality. High paid workers do work unfathomably long hours. If we averaged out their hourly earnings rate this income divide would narrow. At each end of the spectrum resentment runs deep in this country. Those who work long hours albeit with high incomes feel resentment to what they perceive as benefit scroungers and those who milk the welfare system. Intolerance of those on disabled benefits is palpable, even if many are deserving of assistance. Likewise the 'forgotten' classes offered no employment prospects and a failing education system have all but opted out utilising the benefit system to live – as resentment builds towards those who had better social advantages.

It is a heady mix which divides the political spectrum. The 'nanny state' is helping to perpetuate issues and a country gone 'PC' mad, makes it almost impossible to offer constructive reform for fear of being considered elitist (education), racist (immigration), uncaring (social welfare). There is hope, though - debt is a great leveller.

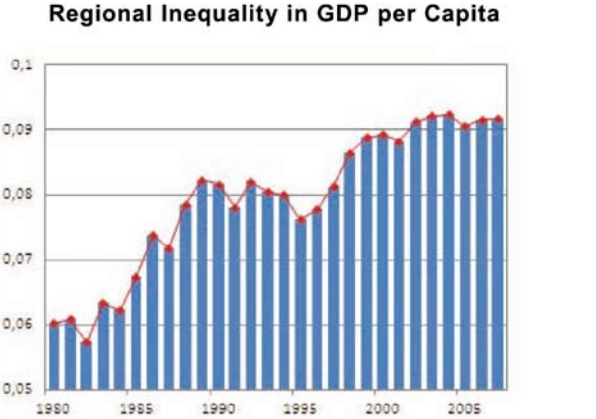
This inequality is magnified when we look at the North and South East of England.



Source: IFS (2010)

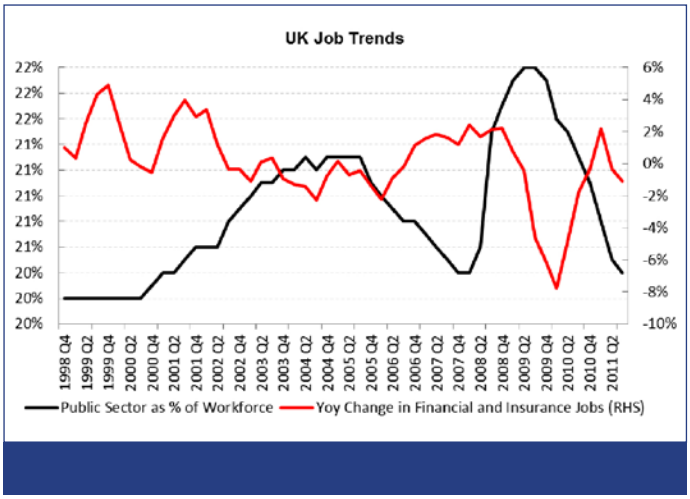


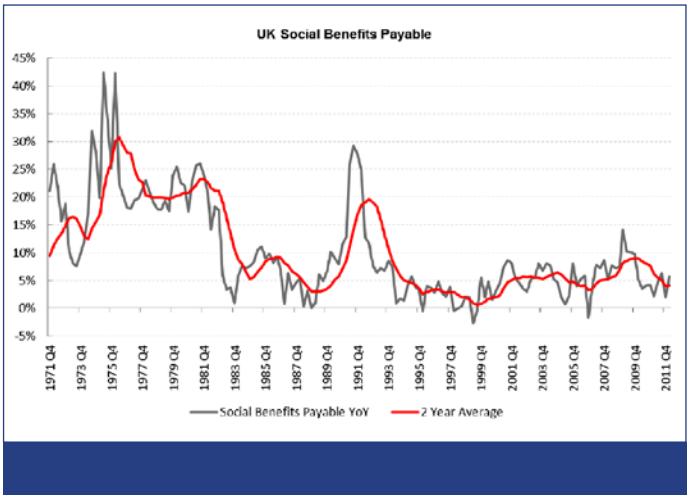
Source: OECD



Source: OECD (2010) Regions Matter

Note; The Gini index is a commonly used measure of inequality, with 0 representing low inequalities and 1 representing high inequalities. Regions UK administrative regions – North East, South East, etc.).





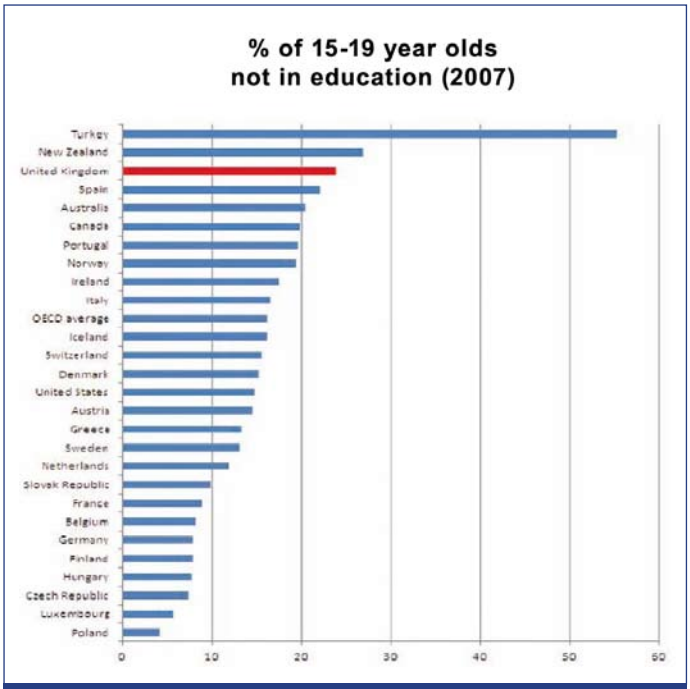
EMPLOYMENT MESS

Unemployment claimants are 4.9 million, including 1.4 million receiving Jobseekers' Allowance, 0.67 million claiming single parent benefit and 2.6 million on incapacity benefit. This accounts for over 21% of the total workforce. Total employment is 22.9 million and 6.2 million in the public sector. Thus 21.4% of overall employment is in the public sector; of course, this doesn't account for those SMEs who rely indirectly or directly on public sector contracts.

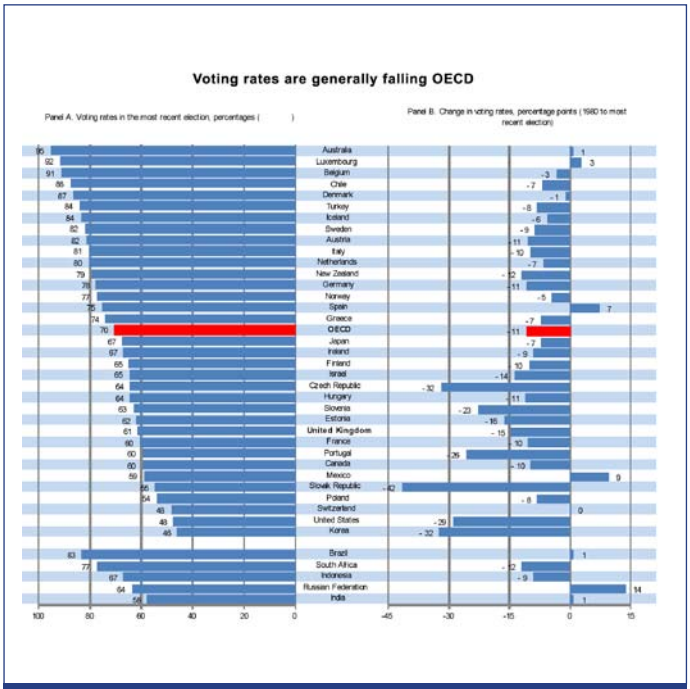
After a surge in the public sector workforce as a percentage of the total workforce in the UK, this ratio has returned to its pre-crisis levels. However, this has been accompanied by a year-on-year recovery in financial and insurance jobs since the crisis. Yet the growth rate barely went positive and the total number of jobs in the financial sector is now shrinking again. The UK is highly geared to the financial sector, so this does not augur well for the broader economy. It is likely we'll again see the public sector (relatively) expanding in the coming years, as the government is forced to take up the slack. Furthermore, a fall in financial jobs is negative for UK tax revenues due to the disproportionate amount of taxes this sector pays.

TRANSFER PAYMENTS

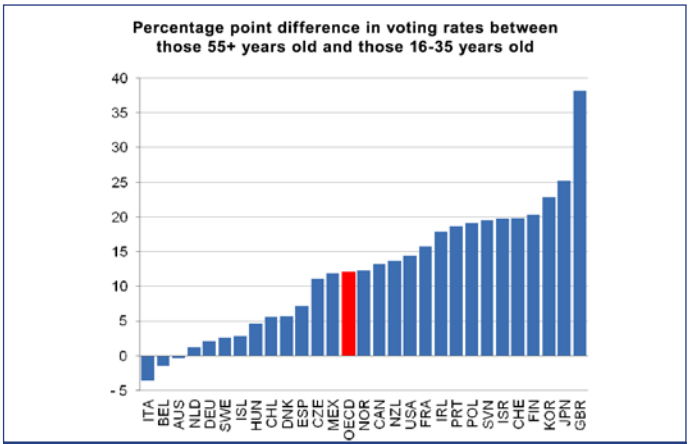
As tax revenues face headwinds, social benefits have fallen from the peak they reached after the financial crisis. However, this will only provide a small relief for the UK government as welfare spending accounts for about one seventh of total government spending



Source: OECD Education at a Glance



Source: OECD Education at a Glance



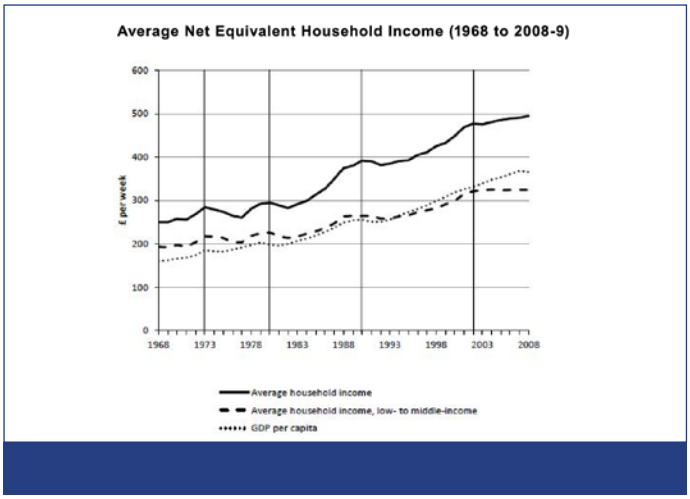
Source: International Institute for Democracy and Electoral Assistance (International IDEA), (www.idea.int), Module 2 and 3 of the Comparative Study of Electoral Systems (CSES) (www.cses.org).

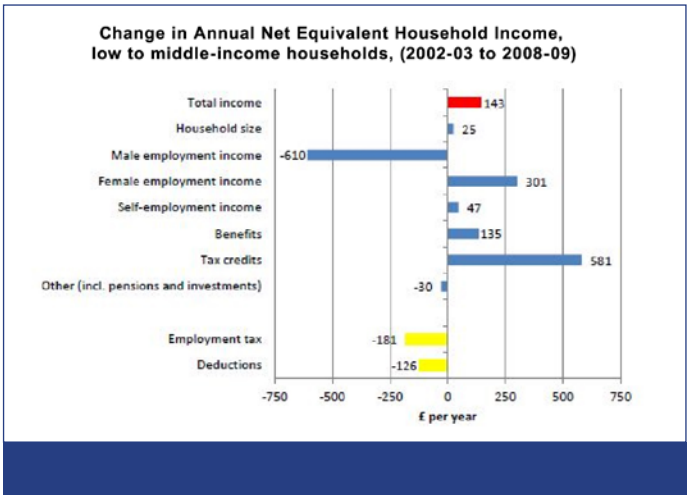
EDUCATION GAP

Alarming in the UK is the high portion of pupils leaving school without upper secondary qualifications. The clear inference here is that income inequality and poor earnings mobility will remain. Education, as we will later show, is one of the most important elements for improving productivity and economic freedom for a nation.

Education is not the only a problem. It is coupled with a disinterest or no interest in voting amongst younger people. This is reflective we subjectively believe of a welfare induced stupor and a mixture of disenfranchisement with both the political and corporate spectrum.

In the UK older people (84%) are much more likely to vote than younger people (46%). The UK gap in voting rates between those under age 35 and over age 55 is 38%, three times the OECD average gap.

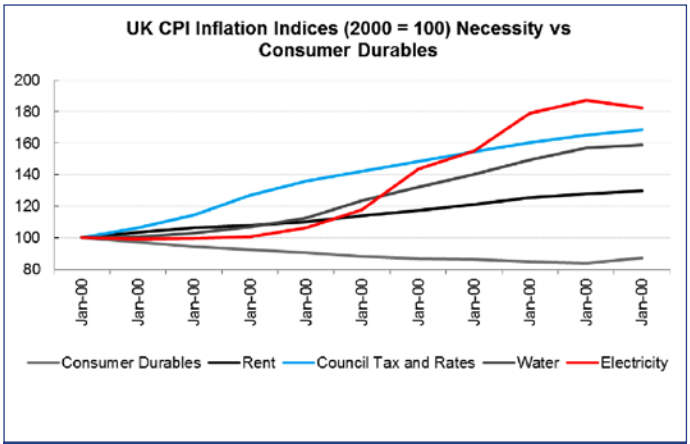




INCOME DEGRADATION

In February 2012 Neil O'Brien, the Director of Policy Exchange, (an independent think tank), wrote in his own personal capacity that he felt the 'squeezed middle', was not a reality. This phrase of the moment that depicts the notion of middle income earners are suffering from a loss in disposable income. Quite simply their earnings are not keeping up with costs; evidence of a loss in their purchasing power. He points to a myriad of micro-statistics that show it's the bottom quintile of earners who are being squeezed (http://www.livingstandards.org/wp-content/uploads/2011/12/Why-did-Britains-households-get-richer-IFS.pdf)

"In little more than a generation, low- to middle-income households have seen a major shift in the sources of their income, while the richest households have seen little change. The key dynamic has been one of diversification; having been dominated by the earnings of a (generally male) main earner, LMI households today receive large portions of their income from female employment and from the benefit and tax credit system. This greater diversity of income sources may reduce the risk of negative income shocks. But these changes mean that LMI households are now more dependent on external support, whether directly (through the generosity of the benefit and tax credit system) or indirectly (through the availability of services, such as childcare, that make dual earning, or lone-parent working, possible)."



Source: ONS

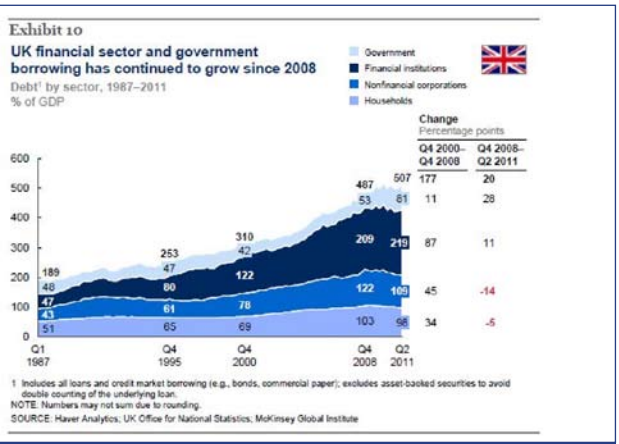
What we find more revealing is that income has been supplemented by tax credits as wages have fallen. The coalition government just introduced changes to income tax credits. The time couples with children will have to work to qualify for working tax credits will rise from 16 to 24 hours. Current spending on tax credits will remain £31.6bn, so in real terms this has fallen.

Over the last decade the second to fifth quartile income earners have supplemented earnings whilst their spending power has been 'squeezed' by substantial rises in their non-discretionary costs (necessities). Official CPI statistics may have CPI rising by 23% over the last 10 years, but energy bills rose by 70% for electricity, 130% for gas bills, council tax bills have risen by 70% whilst water and fuel have risen by 60%. Clearly the CPI is volumetrically adjusted and bears little reality of true inflation in prices. So with only a 42% rise in nominal weekly wages, individuals are unable to make ends meet.

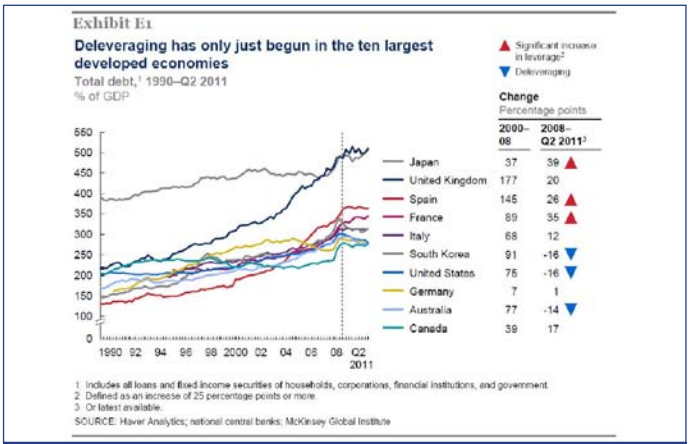
DEBT SERVITUDE

CONSUMED BY DEBT, BUT NO DELEVERAGING

Household debt in the UK has increased in absolute terms since 2008 and stands largely unchanged as a percentage of GDP. Households have spent any extra money they have got in relief from lower interest rates. Lower interest rates are masking underlying problems.



Source: McKinsey January 2012 pp.23



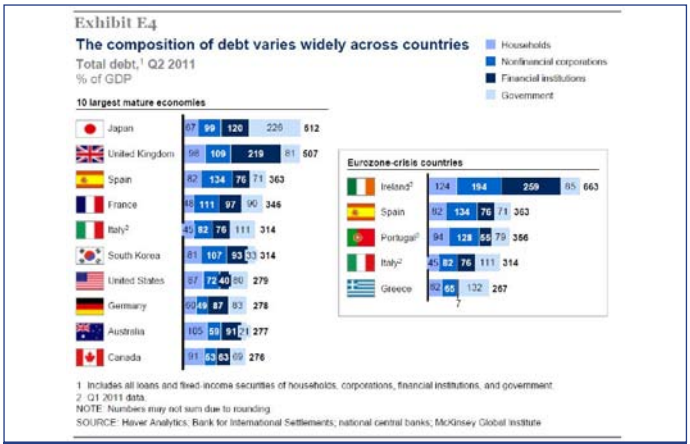
Source: McKinsey January 2012

Debt impotency is no more reflective than the contraction in new consumer lending in the UK. Over-leveraged consumers have no more room to borrow and chastened banks recapitalising have no more room to lend.

The UK has not begun to experience this occurrence. In fact the ratio of UK debt to GDP has risen significantly and faster than any country in the world (except Japan, by a whisker). Both public debt and UK household debt has increased worryingly in nominal terms.

The UK economy is one of the most indebted economies in the world. Measured on society's total debt to GDP the UK is only eclipsed by Japan. Depending on how you calculate the debt, the UK now has 5 times as much as debt as a year's worth of national output. McKinsey recently updated its now famous Debt and Deleveraging Report from 2010 and shows how the UK's economy has actually increased its debt load since the crisis.

This is a remarkable figure given all the talk about austerity, public sector wage reductions and cuts in spending. Importantly, most of the UK's debt sits within the banking system which has raised fears that the UK government (already sitting on 80% debt to GDP) would need to assume those liabilities thus, essentially, like Ireland, go bankrupt overnight.



Source: McKinsey January 2012

A synopsis of UK debt profile:

(A) PUBLIC DEBT

- UK government net debt is £906bn or 60% of GDP
- UK outstanding debt rose 43% in last 3 years, with net debt rising from 37% to 60%
- UK total debt including Financial bailout funds is £2.24 trn or 147% of GDP
- UK unfunded public sector pension liabilities is £1.18 trn or 100% of GDP
- UK total public debt and unfunded liabilities is £3.6 trn or 244% of GDP
- This equivalent to £135,000 per UK household

(B) PRIVATE DEBT

- UK mortgage debt stands at £1.2 trn
- UK consumer debt is £200 bn

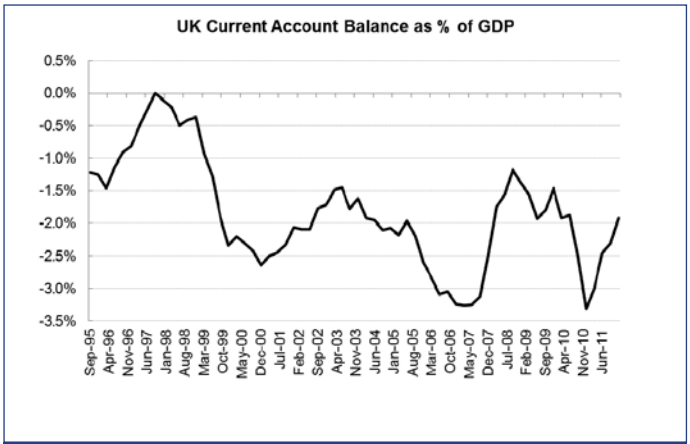
(C) TOTAL UK DEBT

- Total public and private consumer debt is £5 trn or 340% of GDP

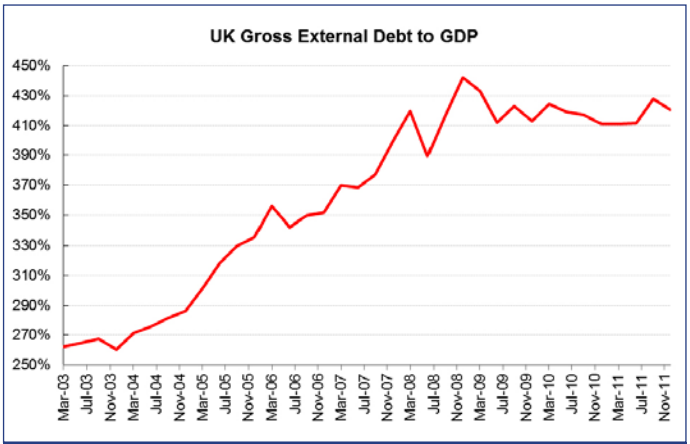
Of particular concern is that UK external debt stands at almost 400% of GDP, higher than any periphery country in Europe.

While the UK runs a relatively modest current account deficit of 2% of GDP, the gross external debt level is massive, standing at more than 400% of GDP. This is mainly a reflection of the substantial amount of external liabilities of the UK banking system.

This amazing figure must be held up against corresponding foreign assets owned by the UK. This yields the net international investment position (NIIP). In a nutshell, the NIIP measures the difference (in notional value) between the stock of assets held by foreigners in the domestic economy and the stock of foreign assets held by domestic companies, households and the government/central bank (FX reserves).

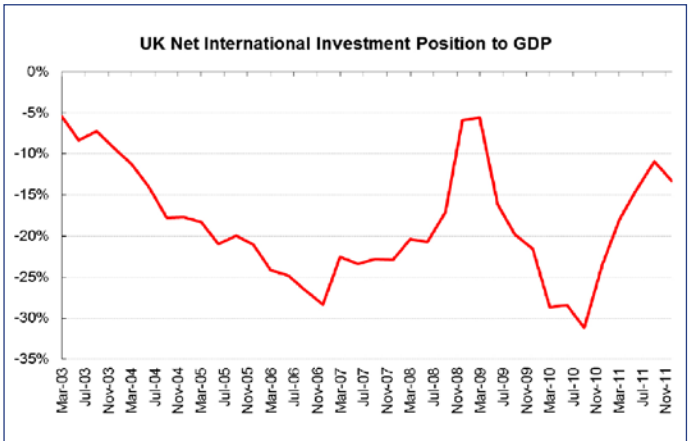


Source: Bloomberg

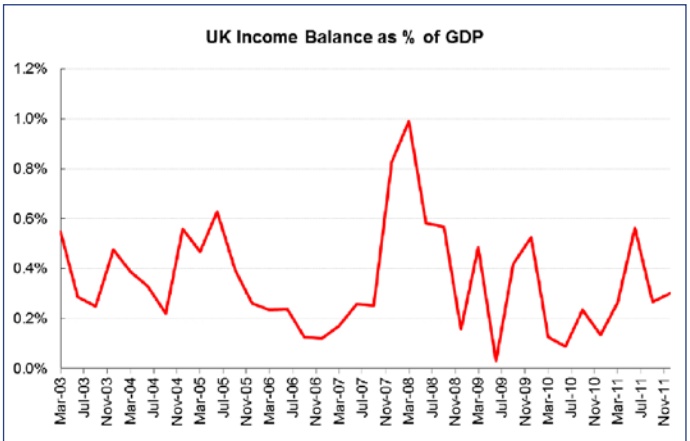


Source: Bloomberg

In the UK's case, this balance stands at just below minus 10% of GDP.



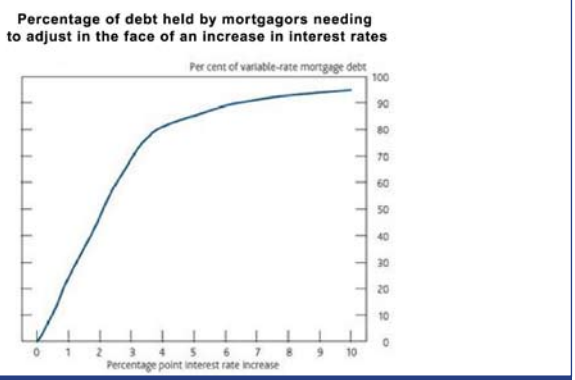
Source: Bloomberg



Source: Bloomberg

While the UK NIIP is down from the lows in 2006/07 and 2010, 10% is a high number as it creates a structural drag on the current account in the form of a negative income balance. However, this is only in theory and the UK is a good example of having a strong (positive) income balance even in the face a negative NIIP.

The size is less important that the fact that it is positive even in the face of a negative NIIP. This suggests that the return foreigners earn on capital in the UK is substantially less than what UK investors (corporate and private) earn abroad. This could be a result of UK investors being more shrewd and adept than their foreign counterparts, but this is an unlikely explanation.



Source: Bank of England, NMG Consulting Survey

Crucially, this then raises the question of how much longer the UK can offer such low returns on foreigners' investment in the country even as the total stock of external debt exceeds 400% of total national income. In our opinion, it is the unwinding of this imbalance which will force interest rates up for UK mortgage holders through stress in UK banks' funding markets, rather than the BoE being forced to raise interest rates.

This is a critical question for the UK as households on variable rate mortgages (which represent the majority) are very sensitive to higher interest rates.

According to the latest surveys analysed by the Bank of England, a 2% increase in the interest rate would see more than 50% of UK households on variable rate mortgages needing to adjust their mortgage, work longer or cut spending. Once the increase rises to 4% we are talking almost all households on variable rate mortgages.

Although the absolute scale of a country's debt is undoubtedly less important than its ability to afford or service those debts, there comes a debt saturation point whereby the government cannot issue any more debt to fund sectors of the economy. A country such as the UK, who runs a balance of payment deficit and whose banks are exposed to both external funding runs and the risk of a loss of capital, may at some point find it difficult to fund itself as a nation. At this juncture no government or BoE interjections will be permissible by market participants in the UK bond markets. BoE purchases will only cause investors to flee more and bank re-capitalisation with domestic debt will only fuel distrust in the currency both internally and externally.

The UK is reliant on overseas energy, it imports more food than it exports, and by running a trade deficit it exacerbates its reliance on overseas funding. Of course over reliance on the financial sector is not advisable when much of the capital is external but neither is penalising the sector going to help growth prospects. A greater reform of banking is needed and the manner in which banks capitalise themselves. **A zero-risk weighting of government debt on bank balance sheets to help them bolster reserves against capital shocks is precisely how we have managed to create a highly unstable economic system as government and bank solvency is now synonymous with each other.** A crucial point to look at when looking at monetary reform in our section titled 'The End Solution'.

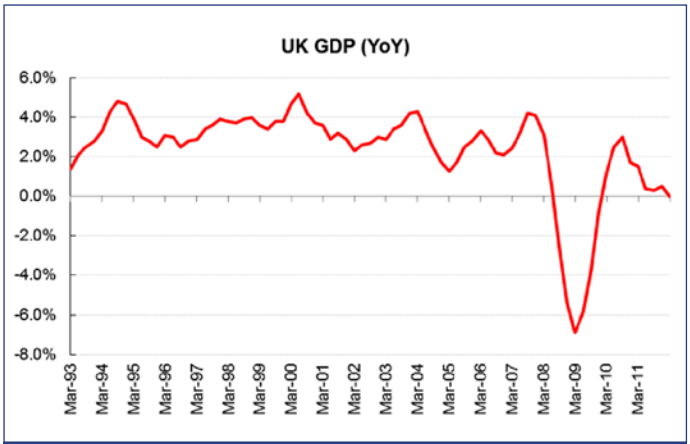
It should be noted on the investment side of the UK balance sheet the UK has managed to sell off most of her assets. Now, although we encourage foreign investment, that does not mean selling off strategic utilities, driven less by the nation's self-sufficiency needs than procuring earnings for management. Click on the HindeSight blog link for more on this - Has the UK sold off the family silver?

Since 2008-09 financial crisis total debt has actually grown across the world's ten largest developed countries, primarily due to the shift on private sector losses to the public sector, where government debt has risen accordingly. This is a normal state of events. Debt usually increases as growth falters in the first few years after such crises; but usually with 4 years growth rebounds and government debt is paid down.

The UK public sector socialisation of private sector losses, which began with Northern Rock and then later RBOS and HBOS, has left the nation with a potential fiscal crisis. The UK's Coalition government can be credited with keeping government borrowing costs low, as it moved swiftly to announce a wide-ranging deficit reduction program. They had the advantage of watching events unfold in the eurozone, which has bought the UK time.

Unfortunately, the fiscal restraint shown may prove harder to implement than the government realises as it would appear that austerity measures have slowed UK growth dramatically. Coupled with global economic headwinds that still rage from the financial crisis, it is safe to say that the amount of 'fiscal space' in which the UK can manoeuvre is narrowing.

The eurozone crisis shows us that sovereign entities must constantly demonstrate fiscal restraint to maintain credibility with investors. Despite a commitment by Spain to cut the fiscal deficit to 4.4 percent of GDP by 2012 (from 11 percent in 2009) government bond yields have risen substantially higher, undermining serviceability of their debt. We put this reaction down to the realisation by markets that the Spanish housing market will decline further, which their banks have crippling exposure to. The losses to the banks will ultimately be socialised as occurred in Ireland.



Source: Bloomberg

FISCAL FICTION

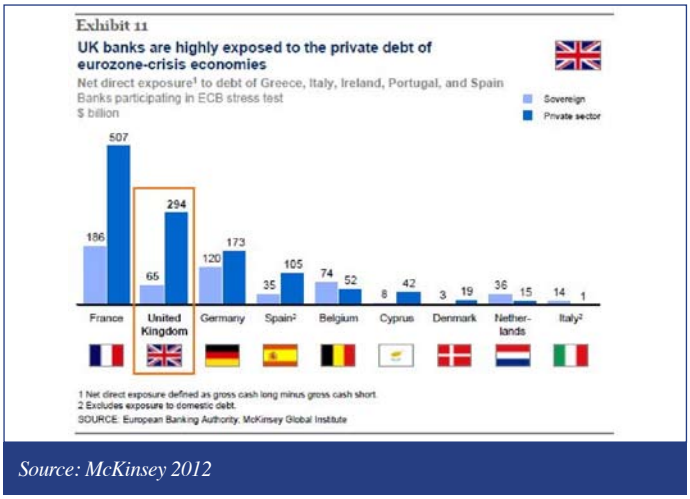
The UK government outlined that the fiscal deficit will decline from 11% of GDP in 2009-10 to 1.6% by 2015-16. The critical assumption here is that growth will average 2.8% allowing tax revenues to be sufficiently higher by 22% in real terms. We believe that there is more chance that Elvis will sing at the Queen's Diamond Jubilee than there is of seeing this growth level.

The plan is to deliver a reduction in borrowing, 20% from tax increases and 80% from cuts to public spending. By the end of 2012 73% of tax increases will have been implemented and only 12% in cuts delivered. Again we believe there is more chance that Elvis will sing at the Queen's Diamond Jubilee, than we see these fully implemented.

The official figures for annual growth in the decade up to the crisis were 2.8%. It defies logic to expect the UK to grow at these rates, especially because we know over 60% of economy was largely driven by debt fuelled growth which cannot be replicated until the nation has de-levered. This will not occur until is forced off the drip feed of low interest rates. Only when serviceability of debt becomes impossible will the deleveraging take place and this will be accompanied with a further contraction in output.

The UK faces a substantial challenge. They need to reduce borrowing back down to sustainable levels while taking into account trade-offs between the impact that the necessary fiscal consolidation will have on household incomes, the quality and quantity of public services provided, and potentially, any permanent damage to the UK economy.

To the credit of the coalition government they set up the Office for Budget Responsibility (OBR) was instigated in 2010 to provide independent analysis of the UK's public finances. This enables them to maintain credibility with the market place - with trust in government at exceedingly low levels, this showed good foresight. As part of their role they must assess the sustainability of the UK public finances annually in a report appropriately named Fiscal Sustainability.



Source: McKinsey 2012

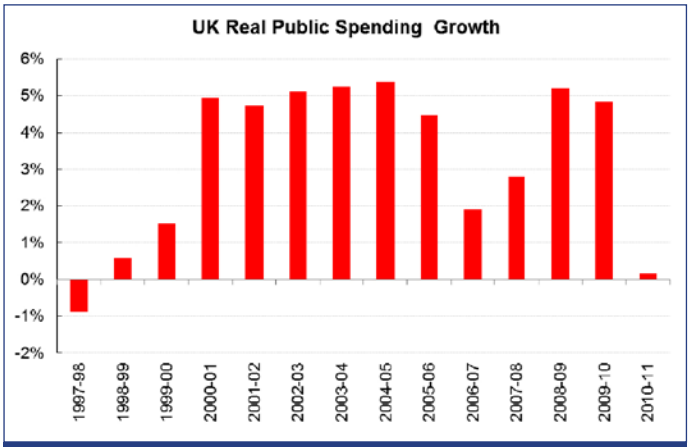
Major UK-owned banks' exposure to euro-area countries

£ billions

	Sovereigns	Banks	Non-bank private sector	Total	Provisions[(a)]	Total less provisions (per cent of core Tier 1 capital)
Greece	1.2	0.9	3.9	6.0	0.3	2.7
Portugal	1.2	1.4	10.6	13.1	0.4	6.1
Italy	6.1	7.9	23.7	37.6	0.6	17.8
Spain	3.5	13.4	40.7	57.5	2.5	26.5
Ireland	2.9	9.2	65.5	77.6	15.7	29.8
Total vulnerable Europe	14.8	32.7	144.3	191.8	19.5	83.0
France	34.7	88.1	60.2	182.9	–	87.6
Germany	38.2	34.8	40.5	113.5	–	54.4
Netherlands	11.7	22.3	45.4	79.4	–	38.0
Belgium	3.4	3.2	4.2	10.9	–	5.2
Total	102.8	181.1	294.6	578.5	–	268.2

Sources: Bank of England, EBA, published accounts and Bank calculations.

Source: Bank of England



Source: McKinsey 2012

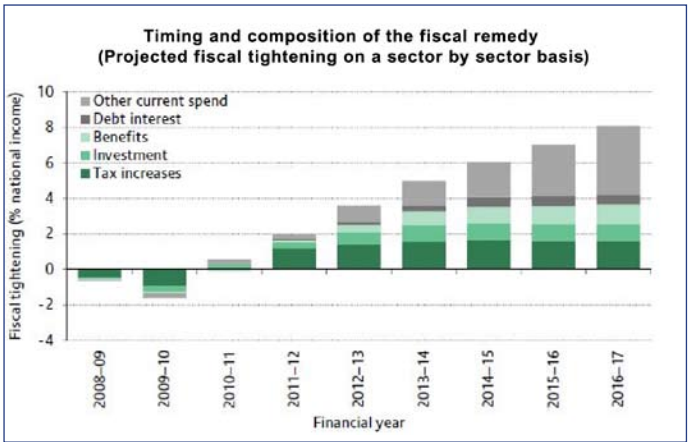
The OBR forecasts net government debt to peak at 78 percent of GDP in fiscal year 2014/15 and gross debt to peak at over 90 percent of GDP. Clearly these are elevated levels that leave no room to deal with economic shocks.

The UK's exposure to the banking sector, and also their exposure to the European debt is £224 bn. It is highly likely, as we articulated in our 2010 piece, the Euro Brady Bunch, that we will see disorderly defaults in the eurozone that will turn the financial and economic system on its head. The fallout from Europe is only going to aggravate the UK problems and terminally.

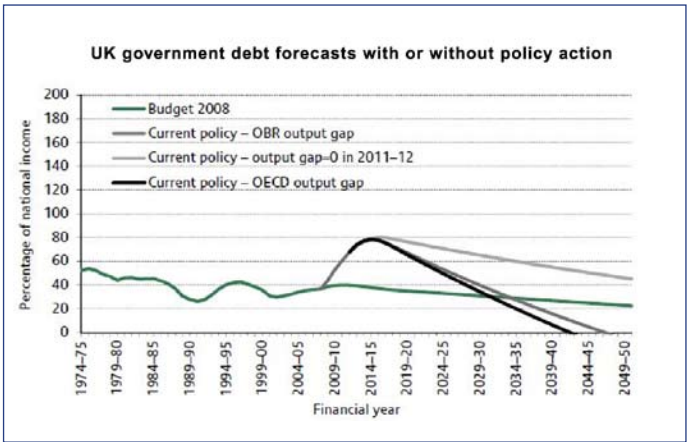
We would note this doesn't account for insurance and pension exposure to the eurozone.

We don't doubt the sincerity of the implementation of an independent fiscal review body but reality is biting and today it looks no more than part of some government propaganda program. The UK government has tried to buy itself time, but the truth is not palatable. It's an illusion. The reality is spending cuts have not been implemented.

A major risk to the government is failure of this implementation. If they want to keep the UK's access to the financial markets they must deliver its planned fiscal consolidation plans. By the end of 2011-12, 73% of the planned tax increases will have been implemented. The spending cuts, however, are largely still to come - only 12% of the planned total cuts to public service spending have so far been implemented, and just 6% of the cuts in current public service spending will have been implemented by the end of this financial year.



Source: IFS



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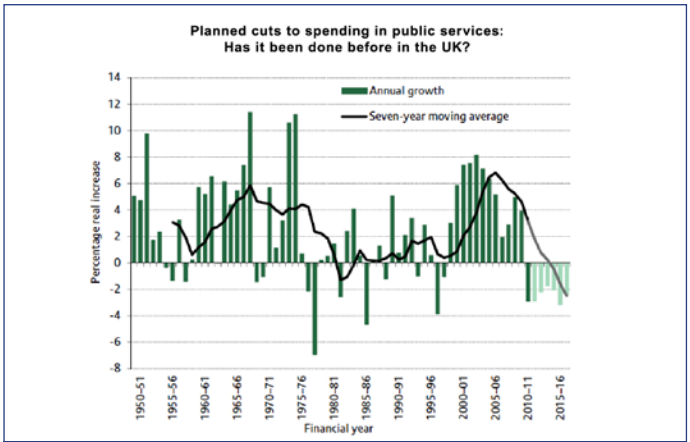


Source: IFS

Planned cuts to spending in public services: Has it been done before elsewhere?

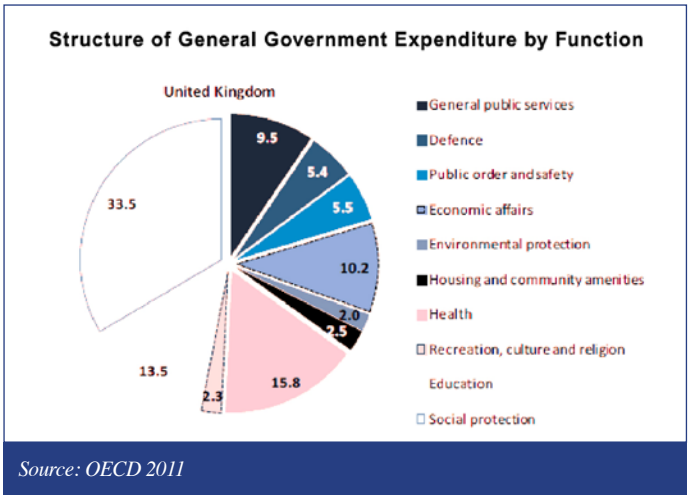
Country	Years covered	Biggest cut %	When	Other cuts ≥1% %	When
Czech Republic	1990–2010	18.2%	1991 & 1992	5.0%	1995 & 1996
				2.5%	2004
				1.6%	2008
Slovakia	1992–2010	13.3%	1993 & 1994	7.3%	1999
				2.9%	2004
Ireland	1970–2010	10.7%	1987–1989	6.8%*	2009 & 2010

Source: IFS

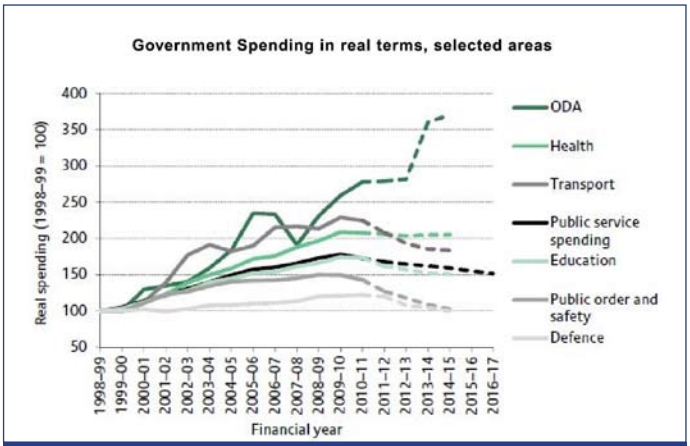
A much greater proportion of the fiscal consolidation is coming from spending cuts than from tax rises. But let's say they do implement cuts. What then? The impact of the remaining cuts to the services provided is difficult to predict; they are of a scale that has not been delivered in the UK since at least the Second World War. On the other hand, these cuts come after the largest sustained period of increases in public service spending since the Second World War. If implemented, the planned cuts would, by 2016–17, take public service spending back to its 2004–05 real-terms level and to its 2000–01 level as a proportion of national income.

The UK has never achieved (or needed to) more than two years' of spending cuts in a row. This time, it needs to undertake seven years in a row.

The scale of cuts is perhaps more relevant than the duration of cuts. The UK plans an 11.2% cut to spending on public services. As we know government consumption rose to a 51% share of the economy. Only the Czech Republic and Slovakia undertook and achieved higher cuts. These are not good comparisons as this was post-Communism and these countries were in disarray.



Source: OECD 2011



Source: IFS

FISCAL FACT

Public spending in truth has risen by 3.4% or £22.6 bn versus 2008-09, and overall public debt to GDP has risen to 84% of GDP, or £413bn. Now although this adheres to form of past crises that public debt rises as the private sector debt falls - we would say politely it is disingenuous to suggest the UK has undertaken any austerity measures.

£bn 2010-11	2008-09	2009-10	2010-11	**2011-12**	vs 2009-10	vs 2008-09
Revenue	£558.6	£528.5	£550.8	**£558.1**	£29.6	-£0.5
Public spending	£658.8	£689.3	£691.7	**£681.4**	-£7.9	£22.6
Deficit	-£100.2	-£160.8	-£140.9	**-£123.3**	(-£37.5)	(+£23.1)
Real GDP	£1,483.0	£1,448.0	£1,475.0	**£1,488.0**	£40	£5
Public debt	£837.0	£1,032.0	£1,129.0	**£1,250.0**	£218	£413
As % of GDP	56%	71%	77%	**84%**	13%	28%

Source: ONS, HM Treasury, OBR, Tullett Prebon

Aging demographics and a mismatch in pension fund assets to liabilities means that fiscal sustainability is not possible. The fiscal costs of an ageing population must be addressed.

OUR OWN FISCAL SIMULATIONS

It is, in fact, quite easy to run scenario analysis on government debt to GDP. We only need to look at a simple framework for the evolution of the stock of debt as a function of three variables.

1) The growth rate in nominal GDP
2) The interest rate paid on debt
3) The government deficit/surplus

Finally, we also need an initial value to for the debt level in time = 0 and we are off. The whole thing can be expressed by the following equation .

$$d_t \quad d_{t\ 1} = pdef_{t\ 1} + \quad d_{t\ 1}\frac{i_t \quad y_t}{1+y_t} + \frac{SF_t}{Y_t}$$

This can be simplified to:

$$d_t = \quad 1+\frac{i_t \quad y_t}{1+y_t} \quad d_{t\ 1} + pdef$$

Which has the following general solution assuming that the stock flow mechanism (SF) is zero;

$$d_t = +A \quad 1+\frac{i_t \quad y_t}{1+y_t} \quad ^{t} + \frac{pdef}{1 \quad 1+\frac{i_t \quad y_t}{1+y_t}}$$

€

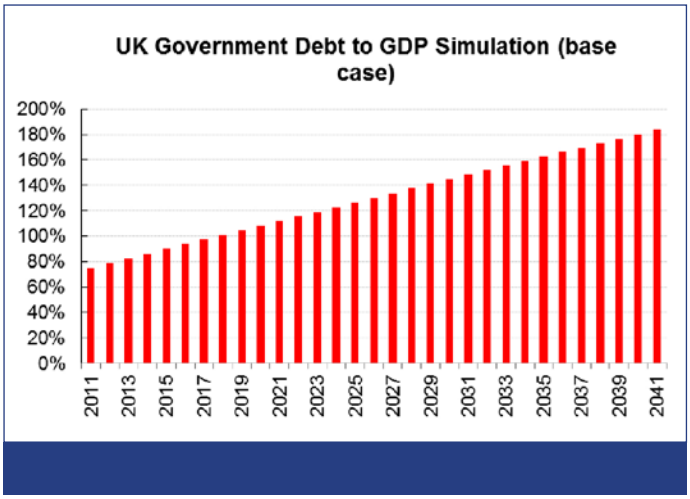
$$d_t = +A \quad 1+\frac{i_t \quad y_t}{1+y_t} \quad ^{t} + \frac{pdef}{\frac{i_t \quad y_t}{1+y_t}}$$

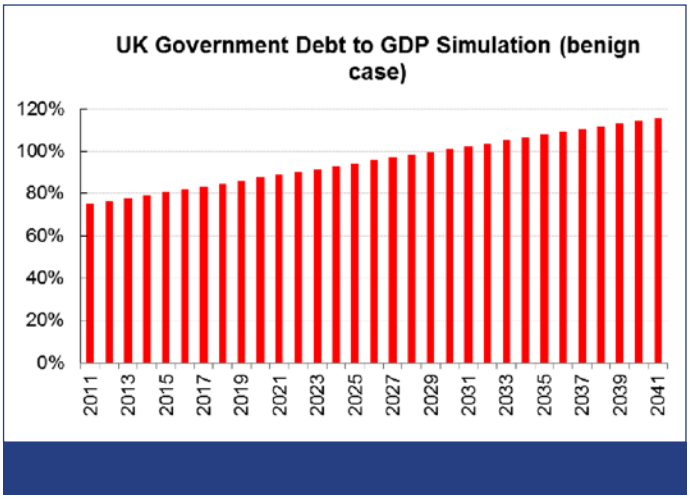
Using the IMF's assumptions for the UK we get the following values for 2011 and the fund's forecast up to 2017 we have.

1) Initial level of government debt to GDP at 75.1%
2) Average growth rate about 2% from 2011 to 2017
3) Average government deficit in the same period 3.7%

As for final assumption on interest rates, this is difficult since one would expect interest rates to increase as the debt itself increases and thus the evolution of debt to accelerate. In the same vein, one would expect a trade-off between growth and the government deficit in the sense that as the government deficit is reduced so is economic growth.

[1]Taken from Danske Bank Investment Research; Research Euroland Debt on a dangerous path, Jan 4th 2010 by Gustav Smidth and Frank Øland Hansen
[2]The constant "A" is assumed positive throughout which is simply akin to assuming that the initial level of debt will be higher than the primary deficit divided by the discounted spread between the interest rate and the nominal growth rate of GDP.





All these feedback loops are beyond our model to deal with, but we can bypass it by running several scenarios through the model above and averaging across to get a comprehensive view of the base case. Plugging the values above into our model and assuming the UK is able to finance itself at the current 10y interest rate of about 1.85% gives the following evolution of debt to GDP.

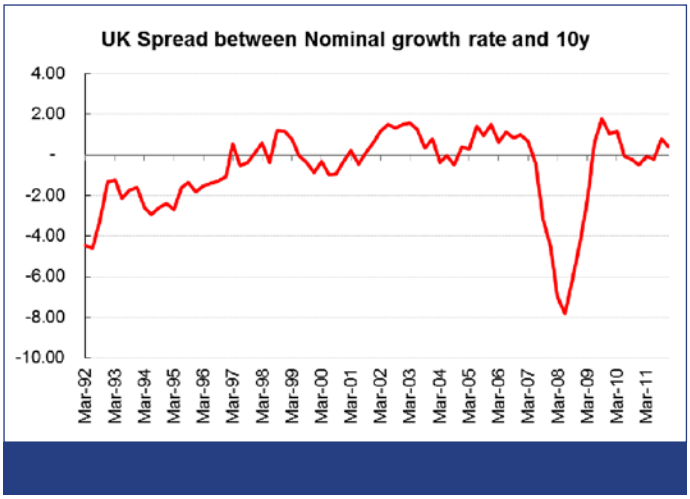
Clearly, and even though we are assuming the UK to grow faster than the rate it pays on its interest rate, this path is unsustainable. The reason is that we are assuming a 3.7% deficit for the whole forecast period, which is unreasonable. **However, the point here is to look at the first couple of years and thus the fact that even we if assume a relatively upbeat growth environment (quick return to trend growth) and record low borrowing costs, the average expected government deficit over the next 6 years is still way too high for UK to live with.**

Going back to the scenario analysis from the IFS, no policy action would mean disaster for the UK even assuming growth forecasts come true and current interest rate levels hold.

In this base case scenario which includes some very positive outlook forecasts (trend growth and low interest rates) government debt to GDP still reaches 100% of GDP in the next 5-6 years. If growth comes in lower than 2%, or if borrowing costs rise, the timeframe is considerably lower!

But what if we assume a lower budget deficit, at 1.5% of GDP, together with the same growth and interest rate assumptions?

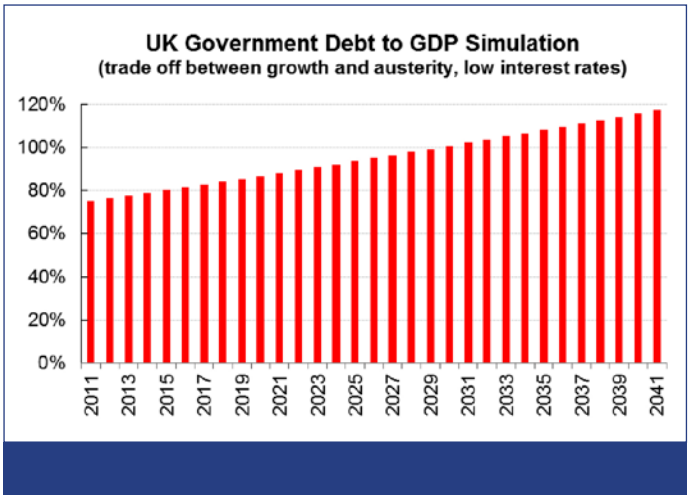
Now, things look much better. Even though the total debt level increases over time, our model predicts a fairly slow path of debt accumulation and one which any finance minister would have no problem arguing how his/her country will be able to outgrow at some point. **This scenario however is very unlikely in the UK.**

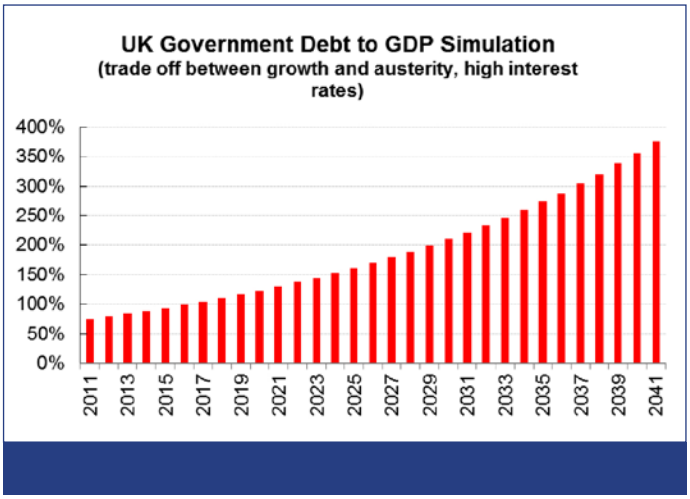


The key question here is then two-fold. Firstly, what level of deficit, can the government live with given trend growth and low borrowing costs? And secondly, what happens if the economy cannot outgrow its borrowing costs? The answer is simple. If the economy can continually outpace its borrowing costs, it can run a given level of deficit for as long as it wants. The problem is, naturally, that one would assume interest rates would increase if the government maintains a deficit forever, which brings us to the second question's answer: given the structural propensity of deficit spending in the OECD, an economy with a persistently lower growth rate than it pays to finance its deficit will eventually and inevitably default.

As we have seen in the European periphery, once borrowing costs rise to a significant premium above the nominal growth rate of GDP, and once this feeds into a need for austerity which further reduces growth, the game is up. The debt snowball rolls, and depending on the government's average maturity of debt, we are talking quarters and not years for the endgame to materialize.

So far, the UK is not in this situation mainly due to very low interest rates and its long-dated debt maturity profile. Moreover, it is important to note that, cyclically, the nominal growth rate of GDP can exceed borrowing costs for long periods, enabling surpluses to be run.





During the ERM crisis in the beginning of the 1990s the UK economy suffered a sharp drop in nominal growth rate relative to its debt costs which was first restored towards the middle of the 1990s. The main point at the current juncture is that if the economy cannot find growth in excess of 1% (which it seems that it can't!), even the current very low borrowing costs are likely to be too high to live with. And of course, if adverse events in the domestic banking sector force the government to step in and/or external pressures force up government bond yields, the situation gets even worse.

Where does this leave us in our simulations then? One of the problems is that we have too many moving targets which are interdependent (interest rates, government deficits and the growth rate).

In order to correct for this, we run two final simulations where we incorporate a trade-off between growth and austerity. As the government moves to lower the deficit, growth goes down. We then run this simulation in a low interest rate environment (1.85%) and a high interest rate environment (6%).

The first simulation with low interest rates look very much like the benign case assumed above. The level of debt will increase, but not alarmingly so. On the other hand, if interest rates were to increase to levels seen in southern Europe, the debt level would quickly run up to unsustainable levels. Indeed, this would also be the case even with interest rates at 4% and 5%.

While the debt to GDP ratio in the UK may certainly increase as the government remains unable to cut the deficit to a sufficient degree, a more likely scenario in the UK is one of a shock akin to Ireland and Spain in which the government will suddenly have to assume bank liabilities en masse.

This would then lead to a discrete jump in the government's liabilities and likely lead to a sharp increase in government borrowing rates.

What we can say for certain is that even if we assume baseline growth projections (which are almost surely too optimistic) and continuingly low borrowing costs, the UK government debt to GDP ratio is going to increase steadily from here.