Eyes Wide Shut

HINDE CAPITAL

Part II. UK Economic Repression and an End Solution



"True individual freedom cannot exist without economic security and independence. People who are hungry and out of a job are the stuff of which dictatorships are made."

Franklin D Roosevelt

"The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries."

Winston Churchill

Part II. UK Economic Repression and an End Solution

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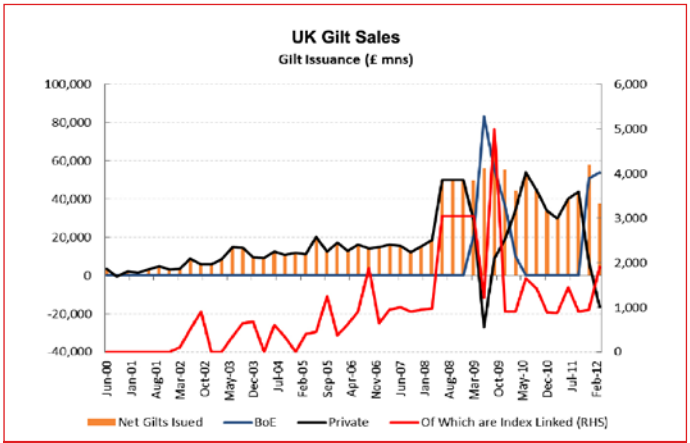
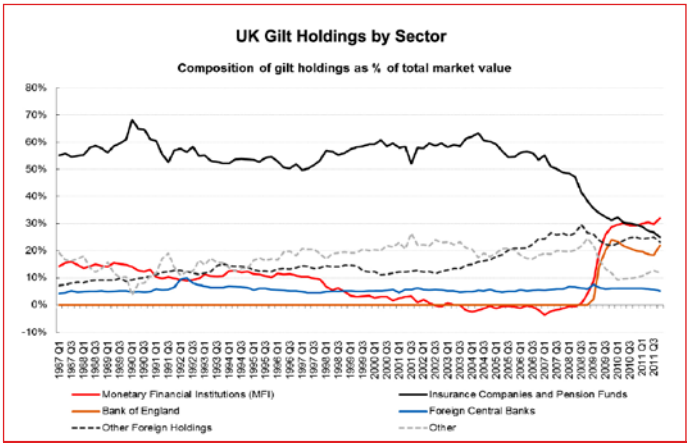
ECONOMIC REPRESSION

DEBT PROFILE

In 2009 the Debt Management Office (DMO) embarked upon a programme of gilt sales that was many times the size of any previous plans, and with a growing fiscal gap the Treasury's projections for the deficit implied that ever larger quantities of gilts would be issued for years to come. This will only accelerate as growth continues to be underwhelming and the fiscal gap widens.



Source: Heriot-Watt University, Edinburgh; DMO

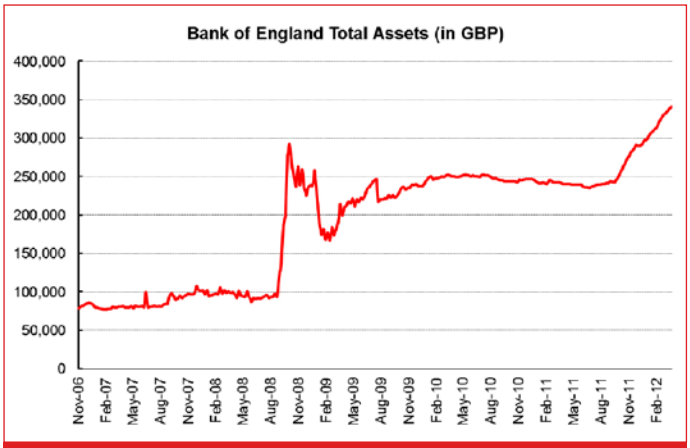


Source: IFS, Barclays Capital, Haver Analytics

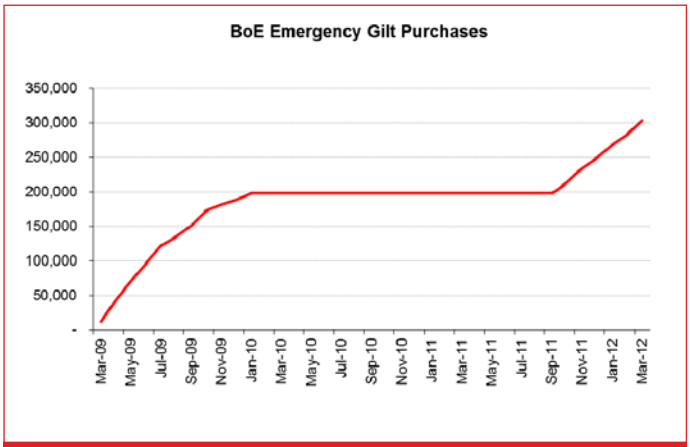
Private demand for UK gilts has remained high as evidenced by the collapse in nominal yields, as investors have sought bond safe havens away from Europe.

UK banks have also had to raise their gilt holdings under new FSA regulatory rulings to help bolster their liquidity and capital positions. To a lesser degree this applies to UK insurance firms and pension funds.

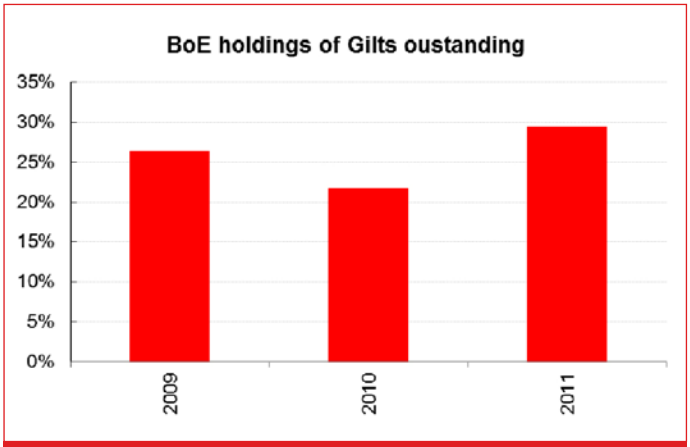
Another facilitation of this increase in debt, even in the face of one of the steepest economic crises since the 1930s, has been an unprecedented increase in the Bank of England's balance sheet, which has allowed the government to borrow at low interest rates. If it had not been for BoE's QE, the UK would most likely not been able to find enough domestic or overseas buyers at such low rates. The discount required would have created additional debt servicing strains on and across the spectrum of private and public sector debt.



Source: BoE



Source: ONS



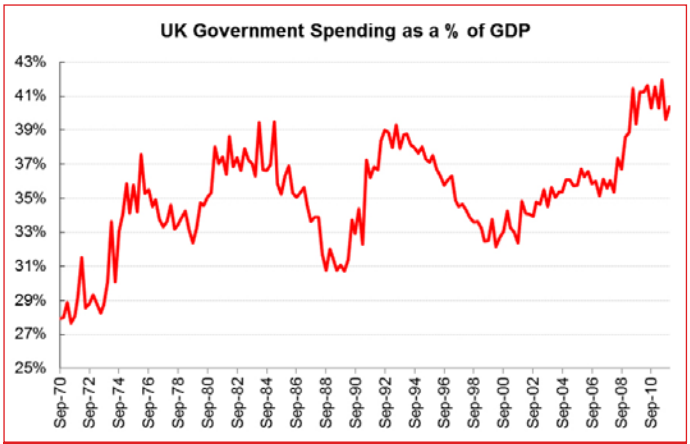
Source: ONS

In 2008, on the cusp of the financial crisis, the Bank of England's balance sheet stood at £100 billion, a number which has swollen to just shy of £350 billion only 3.5 years later. A staggering £300 billion pounds worth of the notional value of the BoE's balance sheet is parked in UK government bonds. This means that the BoE now holds about 30% of all Gilts outstanding.

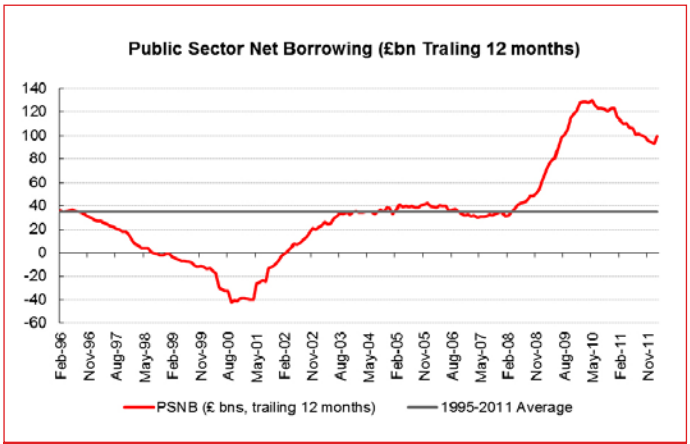
The BoE's willingness to support the UK government's borrowing demand has pushed government expenditure out of its natural range. From 1970 to 2008 the government expenditure share of GDP never rose above 39%.

It has now been running close to or above 40% for three years in a row on the back of a significant increase in government borrowing largely financed by the BoE. Indeed, the BoE has monetized about 60% of net gilt issuance since the Asset Purchase Facility became operational in March 2009. Income tax receipts – the single biggest contributor to government revenue – have been flat to down over the past three years, necessitating the increase in borrowing the BoE has helped shoulder.

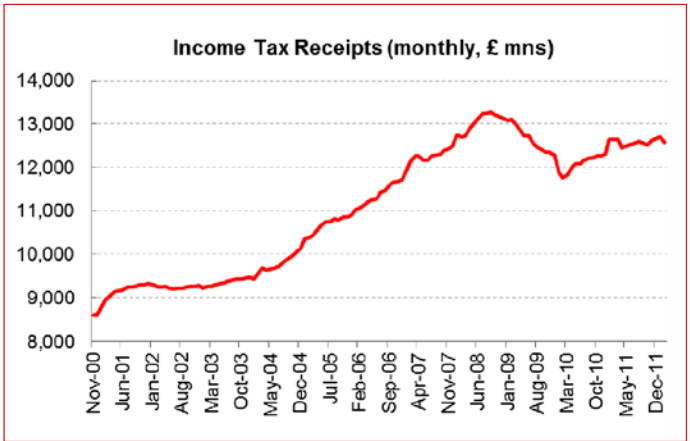
A similar argument has been made recently in relation to government tax revenue as percentage of GDP. Macro Man recently suggested that since 1965 the maximum tax revenue raised by any UK government has been around 36% of GDP. In the US, research has shown that Federal tax revenue cannot sustainably increase beyond 20% of GDP (add state and local taxes and you end up at around 35-40%).



Source: ONS



Source: ONS



Source: HM Treasury

Academic research has come up with similar numbers. Scully (1991) argues that the maximum amount of tax revenue generated by the government occurs, on average, at a tax rate of about 40-45% of GDP, but also that economic growth will start to suffer once the government collects taxes in excess of 20% of GDP. Two points are important to take away.

1. There is a limit to the amount of tax revenues as a share of GDP that any government can extract from the economy.

2. Given the level of expenditure by the UK government, it means that even the maximum level of tax revenues that can realistically be collected cannot cover current expenditure. As a result, significant reductions in government spending are necessary.

The BoE may circumvent this equilibrium but this entails additional costs in the form of high inflation and merely kicks the proverbial can down the road. The UK economy has too much debt and not sufficient current and future income to service it. The central bank may alleviate this issue by generating excess reserves in the banking system (quantitative and qualitative easing), but this may ultimately lead to a loss in confidence for the currency and/or significant cost to the middle class in the form of elevated inflation.

We would consider both qualitative and quantitative easing more subtle forms of financial repression. This term first sprung up in economic literature in works by Ronald McKinnon in 1973, but is more recently associated with Sbrancia, Reinhart and Rogoff. Here is a technical definition given in a paper by Carmen Reinhart:

"Financial repression includes directed lending to the government by captive domestic audiences (such as pension funds or domestic banks), explicit or implicit caps on interest rates, regulation of cross-border capital movements, and (generally) a tighter connection between government and banks, either explicitly through public ownership of some banks or through heavy 'moral suasion'. Financial repression is also sometimes associated with relatively high reserve requirements (or liquidity requirements), securities transaction taxes, prohibition of gold purchases (as in the United States from 1933 to 1974), or the placement of significant amounts of government debt that is non-marketable. A large presence of state-owned or state intervened banks is also common in financially repressed economies. In the current policy discussion, financial repression issues come under the broad umbrella of "macroprudential regulation", which refers to government efforts to ensure the health of an entire financial system."

Sbrancia and Reinhart more specifically explored these subtle forms of repression in helping to reduce raised levels of public debt via 'debt taxation', in an NBER paper, 'The Liquidation of Government Debt'. They depict the period from 1945 – 1980 as illustrative of how a widespread system of financial repression was crucial in 'liquidating' the massive stock of debt accumulated during WWII in many of the advanced countries.

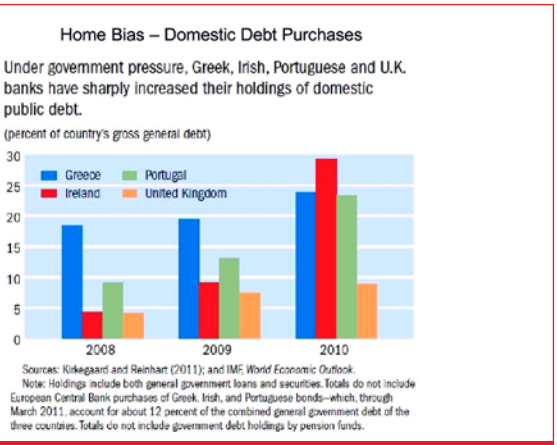
Real interest rates were significantly lower during this this period than in freer capital markets pre WWII and after financial liberalisation. For advanced economies real ex-post interest rates were negative in about half of the years of the financial repression era compared to less than 15% of the time since the 1980s. In fact Sbrancia et al found that for the United States and United Kingdom, the annual liquidation of debt via negative real rates amounted to 3 to 4 percent of GDP per year on average. This equated to a 30 to 40 percent debt reduction of GDP in the course of a decade.

The truth dawns on a nation that in periods of substantial public and private debt overhangs, especially those post banking crises, that growth will not be forthcoming. The empirical evidence by Reinhart and Rogoff (2010) supports this. Quite simply the State needs to find a means of reducing this debt before it becomes unserviceable or investors stop lending it money. They need to capture capital domestically to pay both finance and pay down the debt. The overriding conclusion is that embarking on such steady dosage of financial repression whilst accompanied by an equally steady dosage of inflation does significantly reduce debt/GDP ratios.

The UK experienced its fair dose of financial repression. The gold market was closed in early WWII, reopened in 1954, and it was not until the 1980's that it retracted such behaviour, the Bank of England stopped publishing the Minimum Lending Rate in 1981 and in 1986 it withdrew its guidance on mortgage lending. Prior to these dates the impact of such restrictions was to control the flow of capital back to government institutions and to 'coerce' individuals and institutions to purchase bonds (not gold). Likewise it was not until 1979 that all restrictions on outward FDI were abolished or the Exchange Control Act of 1947 was suspended, allowing relatively free mobility of capital. To assess the effectiveness of a financial-repression tax one can observe the Napoleonic Wars era (1819-59) and the post-WWII era on the UK's public debt. In the former, debt was 260% of GDP, and the latter 238%; growth was comparable at 2.5% per year but it took only 20 yrs in the post-WWII period versus 40 years after the Napoleonic Wars to bring the debt to 100% of GDP. The difference – you guessed it – post WWII there were substantially negative real rates.

Policymakers are undoubtedly taking a leaf out of history today. In the past four years, real rates in 21 advanced economies have been negative about half the time and below 1 percent about 82 percent of the time. This overall turn to lower real interest rates occurred despite the high rates investors have demanded on securities in several countries that have been teetering on the verge of default or restructuring. Real central bank discount rates and bank deposit rates have also been markedly lower since 2007.

The UK Financial Services Authority (FSA) in October 2009 altered financial regulation to require that all UK banks, investment banks or even branches of foreign banks operating in the London market to hold more high quality government securities, as well as reducing their reliance on short-term (wholesale) funding by 20% in that year.



Source: IMF

SOLVENT OR INSOLVENT

The thought of the UK defaulting seems incomprehensible to UK citizens or foreigners, although it happened in the 14th century. Usually a rescheduling of the debt takes place before a nation reaches this conclusion, or a serial debasement of the currency as was witnessed in the reign of Henry VIII (Reinhart and Rogoff, 2009).

Governments will argue that without such subtle (draconian) measures they risk bankruptcy. Government default is often said to reflect a lack of willingness to repay, rather than a lack of ability to repay. This was a point aptly made by Simon Hayes, the UK economist at Barclays. As we have shown there are practical limits to how much a government can tax and also how much money they print, and at some point the inflationary burden of currency debasement is too high. So solvency is really a question of semantics.

Solvency criteria:

- Government financing needs
- External financing dependency
- Financial sector health

How does the UK stack up in these areas?

UK finances benefit from a long average maturity of its debt and the fact that the vast majority of government borrowing is in sterling. Although one could argue the strength of regulation and the rule of law also lower the likelihood of a funding crisis, that didn't help before in past crises. Also the large government deficit and high reliance on external debt are extreme sources of vulnerability.

UK BANKS REPRESSED OR DEPRESSED

Large UK banks' total credit exposure to households, small and medium-sized enterprises, and corporates stands at £3 trn. By contrast credit exposures to financial institutions are only £360 bn.

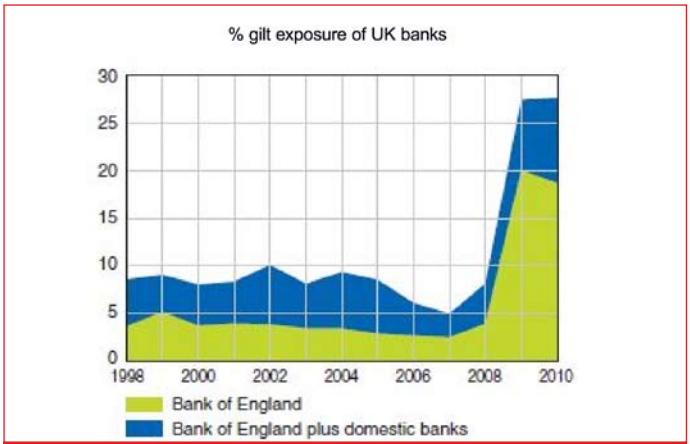
On average UK banks are required to hold capital equivalent to 4.2% of real-economy exposures, compared with 1.8% for intra-financial sector exposures. This reflects the lower perceived risk to sovereign and intra-financial sectors and higher risks in real economic activity.

Basel 2.5 and 3 regulatory requirements have increased required capital for counterparty credit and market risk by around 150% and 70% respectively. **The addition of capital, we suspect, will see increased ownership of UK gilts, as these are afforded a zero-risk weighting on banks' balance sheets, which means capital adequacy ratios can be improved as no reserves need be put aside. Our conclusion is that the regulatory repression will heighten the overall balance sheet risks of the UK - as bank and sovereign debt vulnerability become intertwined.**

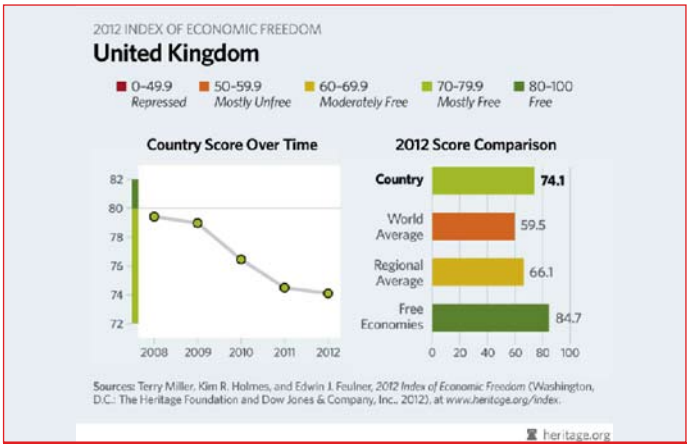
The BoE acknowledged this last point in its latest Financial Stability Report:

The regulatory capital regime is designed to require banks to fund their assets with sufficient capital to maintain confidence in their solvency. But if investors lose confidence in the design of the capital adequacy regime itself, this can pose risks to the resilience of the financial system. At the height of the crisis, for example, market participants lost confidence in the numerator of the regulatory capital ratio — the nominal amount of capital. Investors chose to focus on truly loss-absorbing equity, rather than broader regulatory capital metrics that included debt. Market intelligence suggests that investors are now questioning the reliability of the denominator of the risk-based capital ratio — specifically, the calculation of risk-weighted assets (RWAs).

Furthermore, should rates rise on UK gilts and banks funding rise, then this will pressure debt servicing for over indebted households, which creates a vicious feedback loop as banks are highly exposed to this sector of the UK economy. We pick up again on this point in the section Safe as Houses. The IMF UK Country Report gives a comprehensive analysis of the very real credit exposures of UK banks to the household sector, which could destabilise the banking system.



Sources: Reinhart, IMF (2012)



Source: Heritage.org

In our Wealth of a Nation HindeSight (April 2012) we wrote that over-indebtedness leads to a loss of economic freedom. Mounting public debt, particularly debt that merely boosts government consumption or transfer payments, is likely to undermine the overall productivity growth and lead to economic stagnation and loss of economic freedom.

This transmission to loss of economic freedom, to our mind, has been accelerated by the BoE's expansion of the balance sheet to help finance the fiscal gap. Monetary and fiscal policy have practical limits, which as Sbrancia and Reinhart's work illustrates leads to adaptations in taxation, financial legislation, and regulation, which will enable domestic entities to undertake 'capital conscription' or allow UK fiscal agents to grab capital mandatorily:

- Bank capital and liquidity regulatory changes on reserve requirements
- In extremis nationalisation of money centres and pension companies
- Tax changes, for example, FATCA, FTT or Tobin Tax, Double Tax Treaties (US, UK and Switzerland)
- Resource Taxes, Windfall Taxes, Nationalisation of private assets
- Financial Regulation changes to trap capital domestically – banks, and pension funds
- Domestic capital controls and exchange controls
- Heightened border controls
- Immigration restrictions

The UK is already falling down the Economic Freedom Index as a consequence of such changes:

The UK's very economic freedom has come down to a circuitous relationship between the BoE, the banks, bondholders and householders. Each component threatens to undermine the other and, historically, we believe it has revolved around the housing market. The UK is literally 'Safe As Houses'.

SAFE AS HOUSES?

We believe the UK has been party to a mega-credit cycle which propagated the final stages of a long-wave boom to catastrophic bust, that released some of the immense pressures and imbalances built up over the last 70 to 80 years. It is typically a bust in the property sector that precipitates a wider fallout in the economy. This we saw in the UK and several other countries, although in some countries the authorities have tried to mitigate this eventuality.

It is this excessive imbalance in property debt that has accelerated loss of economic freedom, as governments have employed the institutional framework to prevent a deleveraging of the system.

No more so is this true than in the UK. According to the ONS Blue Book, residential property in the UK is valued at some £3.915 trn, of which £3.696 trn is in the household sector, £117 billion in the public sector and £102 billion in the private sector. The substantial value of the residential sector is inextricably linked with successive government policies, which have fostered a culture of home ownership over many decades. Nevertheless, like commercial property markets, housing markets are prone to volatility, and since the 1970s there have been four periods of boom and three periods of bust, excluding the present downturn.

Business and property cycles both appear to have 4 to 5 years (short cycle) and 18 to 20 years (long cycle). Coincidence? Or does one drive the other? We believe that the property cycle is the leader and is integral to the business cycle. But it is the credit cycle that is inherent in them both, which is why the UK needs to curb the credit cycle to alleviate the effects of this rollercoaster of boom and bust. The typical total value of real estate tends to equal 2 - 3 times annual GDP; in a typical country that constitutes around 50% of total variable-price gross wealth, (Tvede 2006). What society has learned through extensive research is that this price is variable, so property cycles can have an astonishing, and at times catastrophic, impact on an economy.

If one would doubt the impact of housing we need look no further than this extract from a Knight Frank press release in December 1999 called – 'The cost of milk, malt and mansions over the century':

"In 1900 Knight Frank, (a British Estate Agency) advertised a 15-bedroom house near bath for £9,750. Over 100 years later, adjusting for inflation, the price of milk had increased 4,900%, whisky almost 6,000% but a similar property to that of 1900 had increased by 82,000%.

In 1910 a 5-bedroom house in London's Chelsea was sold by Knight Frank for £1,000. Ninety years later that same house was worth £4.5 million, an increase of 450,000%. The price of a basket of luxury goods rose 8,800%, whilst a basket of basic goods rose 12,200%. Clearly house prices have an overriding impact on the wealth and income of a nation year by year.

This would also imply that if we buy and hold property for the long run we will be much better off in real terms; but these numbers do not reflect the impact of buying at the wrong time with too much debt on your an individual's lifetime real wealth."

The UK housing economist Fred Harrison postulates that the housing market operates on a cycle that's formulated on land prices and in turn this dictates economic profitability or not -the peaks and troughs of a business cycle. As the economy grows, so does the demand for land. However the supply of land is fixed, so it becomes more expensive. When prices go up, corporate profits and wages are squeezed at the margin; until such point that prices cannot rise any further because individuals cannot afford to pay them anymore:

"The trouble with money is that it can be converted into a corrosive substance by the housing (more accurately, the land) market." The failing of monetarists such as Professor Tim Congdon is that they believe that it is a mistake to equate the state of the housing market with the state of the economy."

Fred Harrison's roots find themselves in the tradition of *Georgism*, the economic doctrine that holds people own what they create but that 'things' found in nature, most importantly land, belong equally to all. He believed that landowners benefitted economically at the expense of the workers in society as land prices rose in response to economic growth.

We are in agreement with Harrison's assessment that the health of an economy, eg the UK, depends on the condition of the property market. Property is the key factor that shapes the business cycle and not the other way round. But unlike Harrison we assign more significance to the flow of credit from banks and mortgage companies, which enables the credit cycle.

The **credit cycle** is the expansion and contraction of access to credit over the course of the business cycle. The Austrian school regard credit cycles as the fundamental process driving the business cycle. We would concur. The Austrian school can be epitomised for its development of its theory on capital in its theory of the business cycle, (Austrian Business Cycle Theory or ABCT). They argue that business cycles inevitably occur because of excessive growth in bank credit, encouraged by central banks interest rates remaining below the natural rate at which an individual would lend or borrow.

During the upward phase in the credit cycle, asset prices experience bouts of competitive, leveraged bidding, inducing asset price inflation. This can then cause an unsustainable, speculative price 'bubble' to develop. As this upswing in new debt creation also increases the money supply and stimulates economic activity, it tends to temporarily raise economic growth and employment. When new borrowers cannot be found to purchase at inflated prices, a price collapse can occur in the market segment inflated by excess debt, along with a dramatic reduction in liquidity in that market. This can then cause insolvency, bankruptcy, and foreclosure for those borrowers who came in late to that market. If widespread, this can then damage the solvency and profitability of the private banking system itself, resulting in a dramatic reduction in new lending as lenders attempt to protect their balance sheets from further losses. This in turn results in a contraction in the growth of the money supply, often referred to as a "credit squeeze" or a "drying up of liquidity".

It was Kiyotaki and Moore whose research showed that there was a dynamic interaction between credit limits, asset prices and the real economy. They argued that collateral requirements amplify business cycle fluctuations, as in a downturn if there is insufficient income from this capital (collateral), the price of the capital falls and a viscous circle occurs as now the collateral is worth less and the borrower is forced to sell. Lending and borrowing falls and the recession deepens. Irving Fisher depicted this best in his Debt Deflation Theory in the early 1900s. Real estate has become the collateral of a vast amount of private debt. **There is no other means for the ordinary man to obtain sums of money far in excess of his annual income or often life savings than by access to hypothecation of his house; borrowed money collateralised by real estate.** So stable have property prices appeared over the very long run that housing has been one the largest sources of private sector collateral this past century.

CURBING THE CREDIT CYCLE

Many developed nations have become hamstrung by an obsession with land and property. This is very unhealthy for their overall economy. The sooner we realise, and unfortunately reality of time will force the loss of this obsession upon us, that we must not focus our production on this sector and the indebtedness it brings, the sooner a nation can be begin to flourish productively. Such nations need a change of psychology. My home is my castle not my investment or speculation - it's a place we call our own and develop the memories of ourselves and our children; hopefully happy ones.

A nation of would-be property tycoons, and we all know hundreds of them, is not conducive to long-lasting and sustainable economic prosperity. If we all decided to buy and sell houses the economy would become horribly unbalanced, as it has. Think USA, UK, Ireland and Spain and Australia and Canada and, you get the idea. They have all become overly reliant on one sector to sustain incomes at the macro and micro level, even allowing for resource rich countries.

Property cycles propagated by credit availability, the use of property as collateral and a nation's institutional framework to prevent deleveraging in the economic system have amplified swings in long-term economic (business) cycles.

Until such time as we limit the availability of credit and property collateral, as well as the institutional framework of using more credit to prevent a deleveraging of the system; a nation's wealth, such as the UK's, will be severely impaired, time and time again.

The Bank of England under Mervyn King's stewardship failed to recognise that house prices and consumption were as relevant this decade as they were in the late 80s and early 90s, when housing spectacularly rose and then fell.

Although it is encouraging to see that Andrew Haldane of the Financial Stability group of the BoE recognises this issue in a speech Curbing the Credit Cycle in November 2010:

"Credit lies at the heart of crises. Credit booms sow the seeds of subsequent credit crunches. This is a key lesson of past financial crashes, manias and panics (Minsky (1986), Kindleberger (1978), Rogoff and Reinhart (2009)). It was a lesson painfully re-taught to policymakers during the most recent financial crisis.

This time's credit cycle has been particularly severe and synchronous. In 2006, private sector credit across the UK, US and euro area rose by around 10%. During 2009, private credit in these countries fell by around 2%.1 The knock-on consequences for real growth was equally severe and synchronous. Peak to trough, G7 real output fell by 3.6% during the Great Recession."

It would be noted his conclusions on how to curb the credit cycle are complicated by the impact of the shadow banking system that renders monetary policy an ineffective tool in reigning in overall credit in the system.

In the 1970s the Heath government presided over a boom and bust in the UK housing market. The conservatives under Heath decided to liberalise the financial system in the Competition and Credit Control reforms of September 1971, which meant that quantitative controls on lending and interest rate agreements between banks were effectively abandoned. This, coupled with loose monetary policy, and fiscal laxity, propelled capital into property and not investment in industry as the government had hoped. Record level wage settlements funded by this credit-easing system meant that mortgages and other loans could be eroded by inflation. The drop in the real value of houses in the mid to late 70s was camouflaged, and produced real pain as those who struggled to buy homes were consigned to the dole queues.

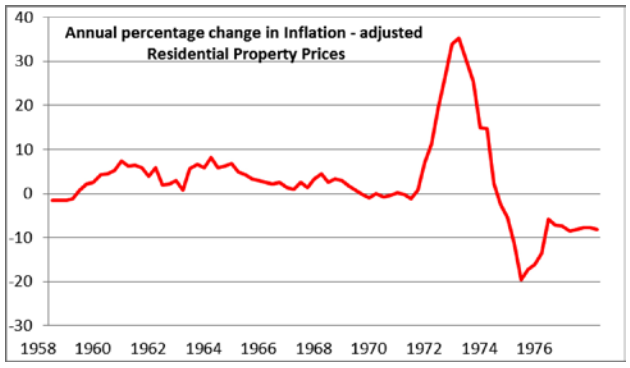
We talk about houses when discussing the growth of prices and value of real estate. However, land values are more volatile and the largest windfalls come from owning land:

- Land prices rose 900%, whilst the building cost index rose 82% in the 10 years post 1979 and the election of Margaret Thatcher

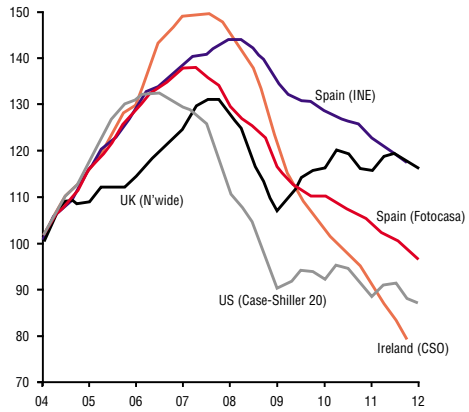
- Land prices rose 101% from 1992 to 1997, compared with 25% increase in House prices

- Land prices rose 333% in the 5 years post Blair election win, building costs rose 30%

Fast forward three decades and we can see not much has changed. In the 1970s institutional demand for property was a factor as upward-only rent reviews, borne out of an inflationary environment encouraged investment in commercial real estate. Brown's legislation changes opened the doors to pension funds to invest equally indiscriminately, underpinning prices.



Source: Nationwide (property) and ONS (retail price index)



Source: Standard Chartered

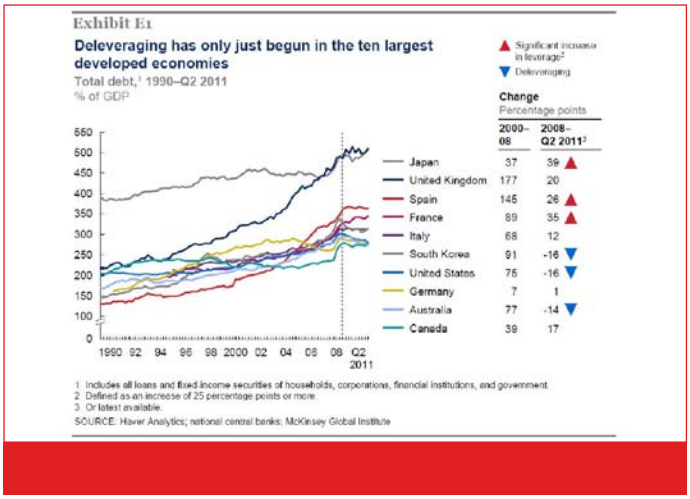
The UK property market, prior to the financial crisis, was one of the most overvalued in the world, fuelled by ease of access to cheap credit. Since then, prices are almost 12% off their peak, although they have subsequently bounced 9% from their nadir in 2009. Indeed, as the chart above shows the UK is the only main housing market to have had any sustained bounce. **We argue the UK is at high risk of a further downturn in housing as rates have bottomed and the mortgage market becomes significantly more sensitive to moves in rates.**

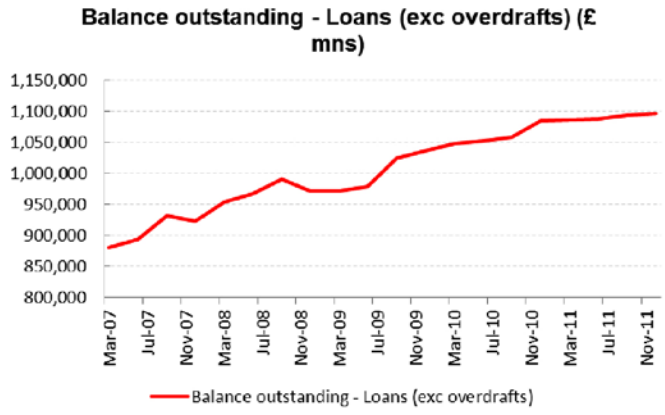
In response to the crisis, banks in the UK and further afield tightened credit conditions dramatically. As house prices fell, many mortgage holders slumped into negative equity. Confidence plummeted. There was a real risk of a depression as a vicious circle of falling property prices impacted banks' balance sheets, who contracted lending further, having a detrimental effect on the broader economy.

The Bank of England cut rates sharply in 2008 and 2009 to an historic low of 0.5%, where they languish currently. During the credit boom, in the lead up to the financial crisis, so-called tracker mortgages became very fashionable. Slightly different to the ARMs (Adjustable Rate Mortgages) pervasive in the US, in the way they had super-low 'teaser' rates, they were however similar to these products in the way they were responsible for helping fuel the mortgage market, and thus the property market, in the UK.

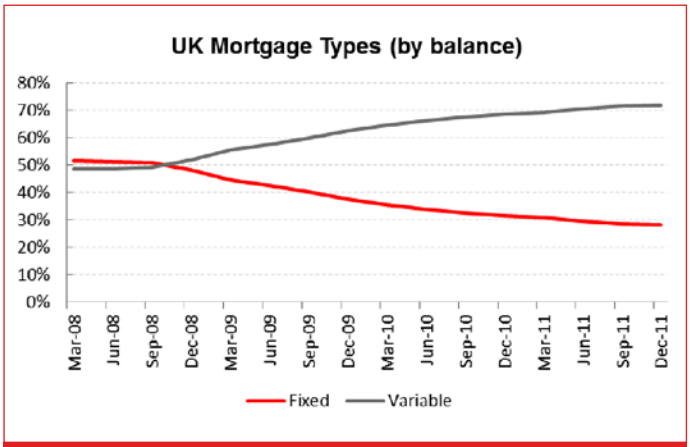
Tracker mortgages were, by definition, directly linked to the Bank of England's base rate. The BoE thus knew by rapidly cutting the base rate this would 'mainline' confidence back in to the economy as borrowers who would otherwise have had to default on their loans could continue to afford their repayments as they fell sharply.

The belief was that the rate cuts would be a temporary measure and, once confidence was restored, rates could be returned to more normal levels. So far, this has not happened. And, in fact, it is not likely to happen for the foreseeable future. As the following chart from McKinsey shows, total debt to GDP in the UK is one of the largest in the world.





Source: FSA



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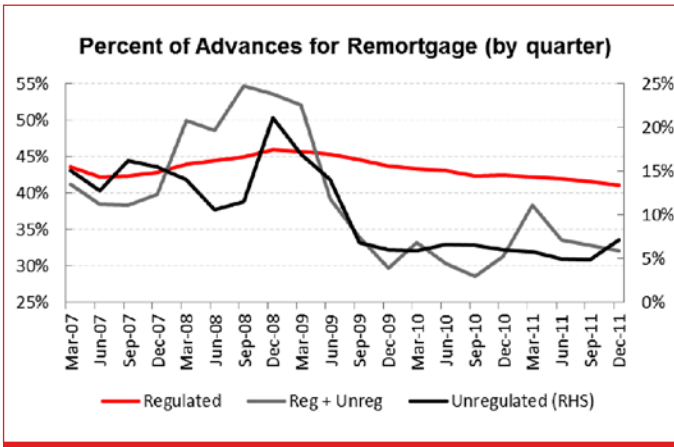
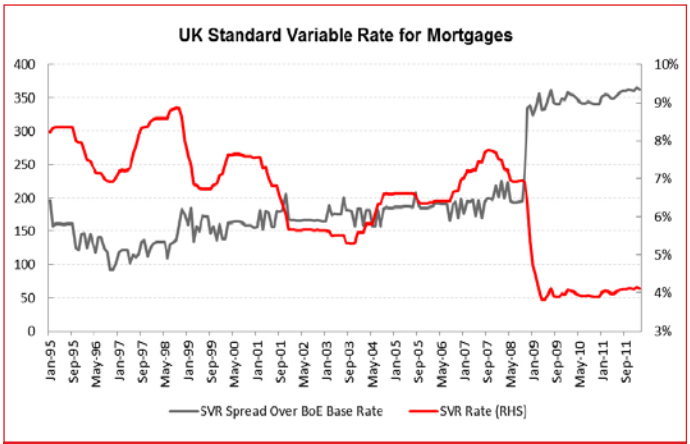


Source: FSA

We reiterate our point made earlier, the UK's total debt to GDP has not gone down, and has in fact increased since the onset of the crisis. Most other major countries, other than Japan, have shown some sort of deleveraging over the past few years. The UK, however, has grown addicted to low rates, protecting borrowers from default. **Low rates in the UK are now imperative to keep the economy from a renewed and protracted slump.** Furthermore, low rates have helped keep the mortgage market growing over the last few years. Indeed, in terms of total loans outstanding, the trend rate of increase has barely decreased. Again, no sign of deleveraging.

There are signs the problem could be coming home to roost. In 2007, the majority of mortgages were fixed rate. Fixed rate deals in the UK tend to be much shorter than in the US (2 and 3 year deals are very common; finding non-punitive deals longer than 5 years is very difficult). As many of these expire, lenders automatically move on to the SVR (Standard Variable Rate). In the past, mortgage holders tended to remortgage but, with banks' tighter lending conditions, this is more difficult to do. Advances for remortgages have declined since 2008 (grey line, in bottom right chart, above), from 55% of mortgages per quarter, to only a third today.

Indeed, fixed rate mortgages, from composing over 50% of outstanding mortgages (by balance) in 2008, now only account for less than 30% of mortgages.



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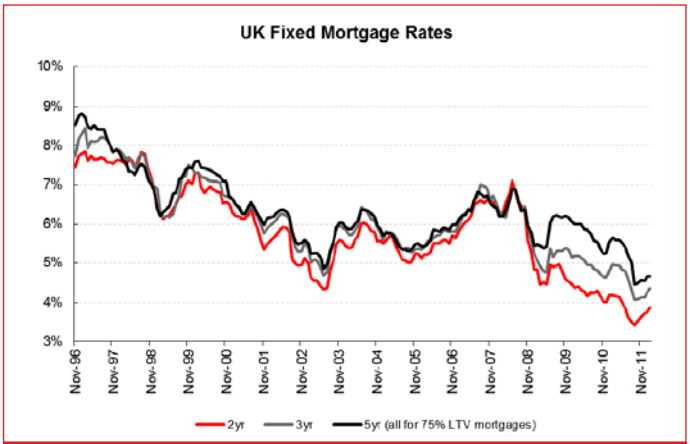


Source: FSA

The SVR is almost always higher than the main fixed rates, with it being eg on average 95bps (0.95%) higher than the 2 year rate over the past decade. So, it is highly likely any borrower will have a sudden increase in their monthly repayments when they come off the fixed term. Indeed, the average SVR is currently 75bps higher than the average 2 year rate. **Using the average loan value of outstanding mortgages, this equates to an increase equivalent to almost 25% of the UK average real disposable income (equivalent to over £900 per year).** This will have a material impact on already straitened household balance sheets. (As an aside, the average real disposable income per head in the UK has fallen since 2007, from £3,695 per year to £3,645 today.)

The greatest risk, with the high (and growing) percentage of mortgages outstanding on variable rates, is the increased probability that rates move higher, which would immediately impact many borrowers at around the same time. SVRs are likely to move if the BoE raises rates, but since 2009, the spread between the BoE's base rate and the SVR has risen sharply. **In fact, the SVR has continued to trend up in the absence of any rate moves from the BoE at all.** Banks are in no mood for giving any quarter to borrowers as they try to meet much stricter capital ratios soon to be imposed. Further, fixed rates, as well, look to have bottomed and are moving up. Mortgage holders will already be beginning to feel more stretched from increased repayments.

Moreover, rate sensitivity is higher the closer rates are to zero. Below is a table illustrating some of the effects from rate increases to the average mortgage holder. For comparison, we show how it would have impacted before the onset of the financial crisis.

	AVERAGE LOAN (£S)	AVERAGE SVR	YEARLY REPAYMENT (£S)	+25BP INCREASE IN VARIABLE RATE (% OF EXISTING PAYMENT)	+100BP INCREASE (% OF EXISTING PAYMENT)	+200BP INCREASE (% OF EXISTING PAYMENT)	+500BP INCREASE (% OF EXISTING PAYMENT)
Q1 2007	84,391	7.19%	6,068	3.5%	13.9%	27.8%	69.5%
Q4 2011	97,930	4.10%	4,015	6.1%	24.4%	48.8%	122.0%

Source: FSA

The table shows that a 25bp increase in the SVR would have almost double the impact today than it would have had in early 2007 (when the base rate was 5.25%), adding 6.1% to the average mortgage holder's monthly repayment. However, when rates begin to move up, there is a reasonable chance they could move much higher (this may be 'unthinkable', but most thought that was the case when the BoE started cutting rates, that they couldn't surely breach the 2% all-time low, which they very quickly then did). A 500bp increase in Bank rate, based on today's figures, would result in a more than doubling of the average repayment. Many borrowers would be unable to cope and would be forced to throw the towel in.

As real wages continue to fall and nominal wages dwindle to a sub-2% year-on-year pace, much of any higher mortgage servicing costs would have to come from disposable income. The table below shows the impact of mortgage rate increases on disposable income.

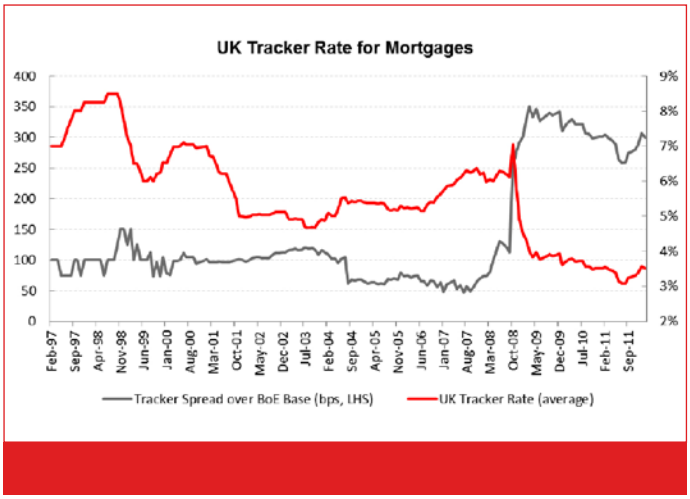
	AVERAGE LOAN (£S)	AVERAGE SVR	YEARLY REPAYMENT (£S)	+25BP INCREASE IN VARIABLE RATE (% OF REAL DISPOSABLE INCOME)	+100BP INCREASE (% OF REAL DISPOSABLE INCOME)	+200BP INCREASE (% OF REAL DISPOSABLE INCOME)	+500BP INCREASE (% OF REAL DISPOSABLE INCOME)
Q1 2007	84,391	7.19%	6,068	11.4%	22.8%	45.7%	114.2%
Q4 2011	97,930	4.10%	4,015	13.4%	26.9%	53.7%	134.3%

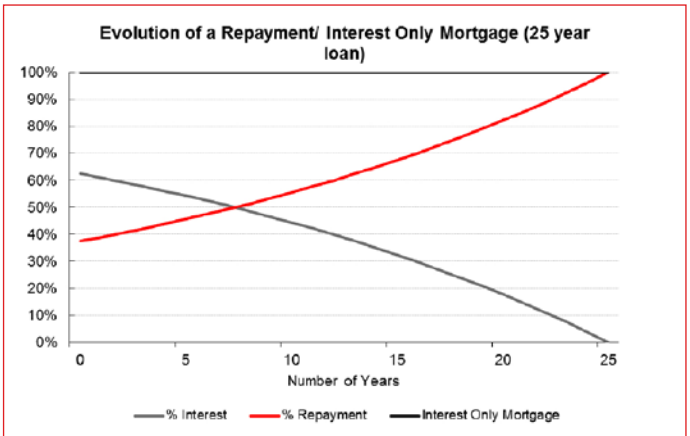
Source: FSA

Here, even a 25bp increase in the variable rate would eat up about a seventh of the average worker's disposable income. A 5% increase in the rate would completely overwhelm it. **We draw your attention back to the chart above on the composition of the mortgage market by type: over 70% of mortgages (by balance) are variable rate so these effects will be now be much more widespread than they were even a few years ago.** Significantly fewer borrowers are now able to weather any storm behind the shelter of a fixed rate.

Tracker mortgages, too, provide less insulation against rate rises than they once did. The spread between the BoE Bank Rate and the average tracker rate rose abruptly after the financial crisis, and although it trended down slightly afterwards, in recent months it has begun to turn up once more.

There are already signs of stress. According to the FSA, the UK banking regulatory body, lenders are showing forbearance for borrowers who are struggling to meet repayments, by moving them onto cheaper-to-service interest-only mortgages. Not only does this store up the fundamental problem of overstretched and insolvent lenders for later, it too increases the sensitivity of borrowers to rates.





Source: FSA

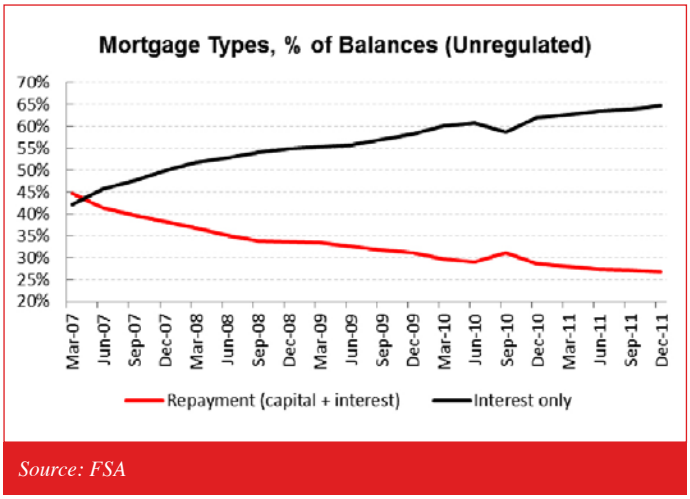
A repayment mortgage, as can be seen in the chart above right, evolves so that at the beginning of the repayment schedule the loan is mainly interest, and as repayments progress, more and more of each payment is capital repayment. The example above is for a 25 year mortgage with a 4% interest rate. By definition, 100% of the monthly repayment for an interest-only mortgage is interest.

If rates move up to 6%, the monthly payment for a repayment mortgage increases by about 22%, but for an interest-only mortgage it is 6%/4% = a 50% increase. On a £250,000 loan, this is an increase of over £400 per month. **Interest-only mortgage holders - many of who will be coming off fixed rates as is the case with the broader market - will feel the pain of higher rates much more acutely than those on repayment mortgages.**

This trend in switching holders to interest-only mortgages is not evident in the statistics for lending for all types of loan. However, the data for what the FSA terms as 'non-regulated' loans (includes buy-to-let, second charge lending, etc), depicts a clear increase in interest-only mortgages. Some of this may be due to the effect of a net paying down in repayment mortgages (or default, but the repossessions and arrears data do not support this), leaving a greater percentage of the total interest-only mortgages (which is not paid down by definition). Nevertheless, interest only accounts for over 40% of UK mortgages.

The non-regulated sector has fallen significantly as a percentage of all lending in part, no doubt, to the much tighter credit conditions extant in this type of lending.

However, non-regulated lending may be a leading indicator for lending conditions as a whole, as these borrowers will tend to be more leveraged than borrowers in the regulated sector. But fundamentals are the same in both, namely that rate sensitivity is growing and rates looked to have bottomed. We can already see the beginnings of stress in the non-regulated sector, as this chart from the CML (Council of Mortgage Lenders) shows: the percentage of buy-to-let mortgages taken into possession is increasing (while the percentage for owner-occupied properties is declining for now).



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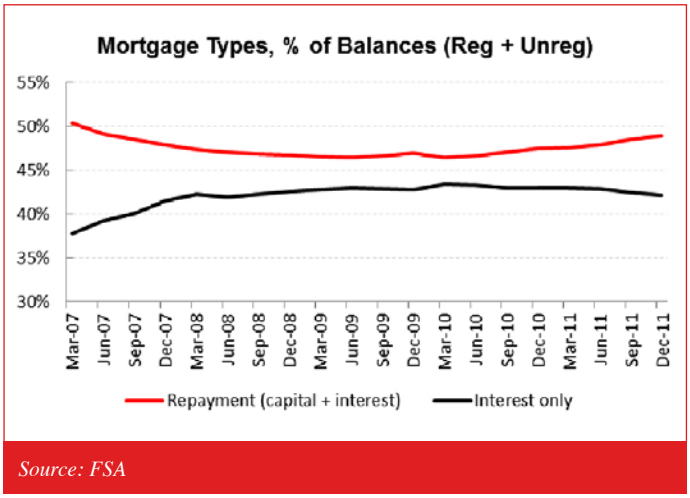

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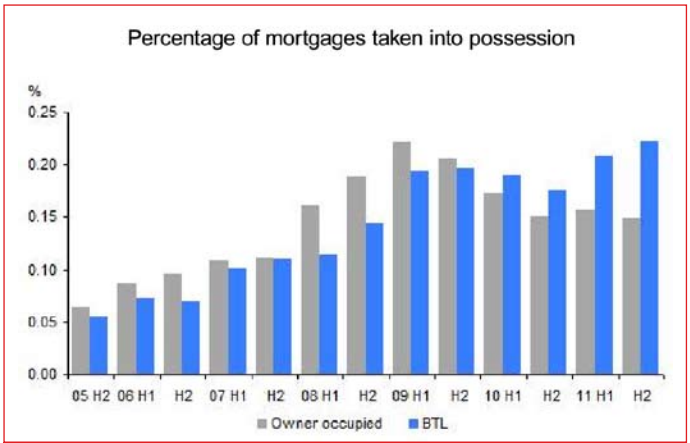


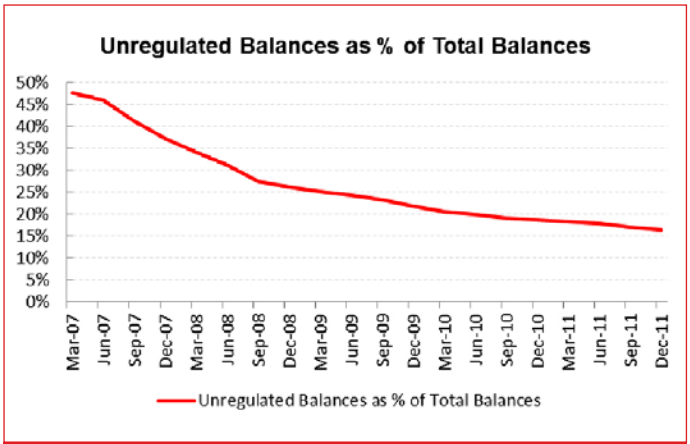
Source: CML

The low absolute number of repossessions and borrowers in arrears in the UK will mask underlying difficulties borrowers have servicing their loans. Unlike the US, most mortgages in the UK are not non-recourse, therefore banks have a claim on a borrower for any shortfall arising from the sale of a repossessed property. In the UK, banks can pursue the debtor for 12 years or more (12 years in England, 20 years in Scotland). This will help ensure mortgage holders in the UK will continue to make their payments far beyond the point they would otherwise if they had a non-recourse loan. **But at some point, as rates continue to rise, this will become impossible, and we would expect to see the number of repossessions rise quickly.**

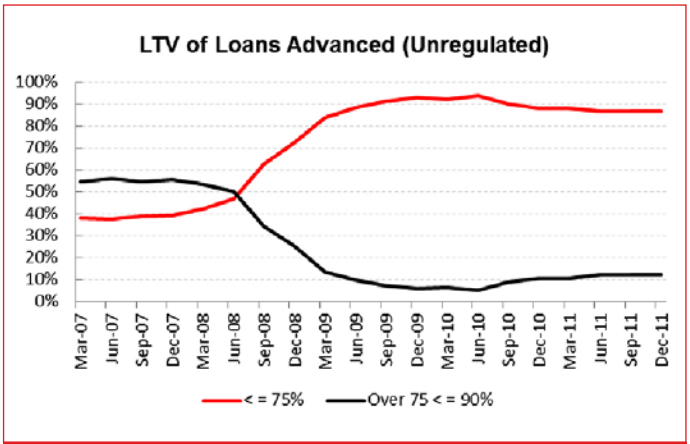
The UK experienced its first major property bubble in the 1970s. Back then, credit was much more tightly controlled, but residential property prices were still increasing over 30% on the year at their peak in 1974. There were a number of reasons for this, including relaxed conditions allowing high street banks to compete with building societies on originating residential mortgages; an over-optimistic assessment of property values; and a Government-imposed cap on the mortgage rate.

There was also a minimum lending rate (MLR) that sat at just under 12% in 1973. But even as property prices fell from their overvalued levels and rates remained at double-digit levels, there were not mass defaults. This was because lenders very rarely lent more than three times income and the rampant wage inflation of the 1970s (due to heavy unionization) enabled borrowers to keep making repayments. As a result, the income-to-house price ratio fell from 3.8 to its long-term average of 2.8 by the mid-1970s, without significant repossessions.

Today is different. Real wages in the UK continue to decline, and the income-to-house price ratio remains over 5, having reached a peak of 6.5.



Source: Nationwide, ONS



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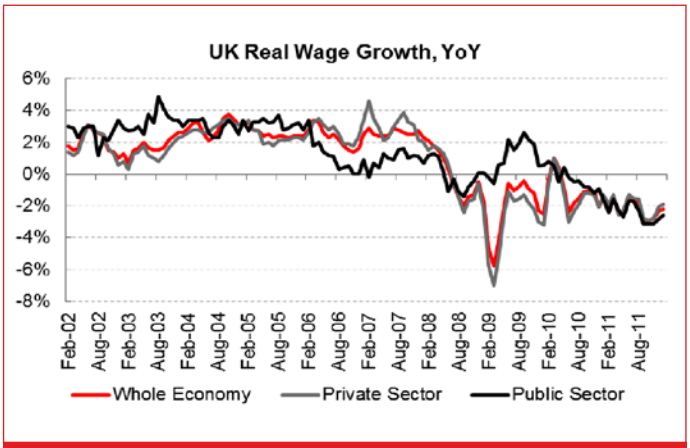
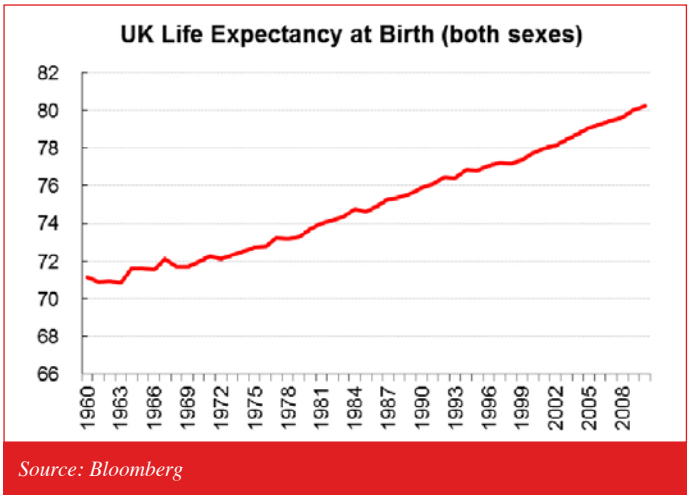
Source: Nationwide, ONS



Source: Bloomberg

The composition of the mortgage market in the UK represents an increasing fragility in UK property. Borrowers are becoming more tied to variable rates, leaving them exposed to base rate rises from the Bank of England, or rate rises independent of the BoE from still beleaguered banks looking to bolster their capital ratios. Both fixed and variable rates look to have bottomed and are turning up even though the base rate remains anchored. Forbearance by lenders only defers the problem and, in the case of interest-only mortgages, could exacerbate the problem as borrowers are more sensitive to rate rises. These structural changes to the mortgage market leave UK property vulnerable to another correction.

The income-to-house price ratio will mean revert, as it always has. Unlike in the 1970s, though, this time it is likely house prices will fall to meet wages rather than the other way around.



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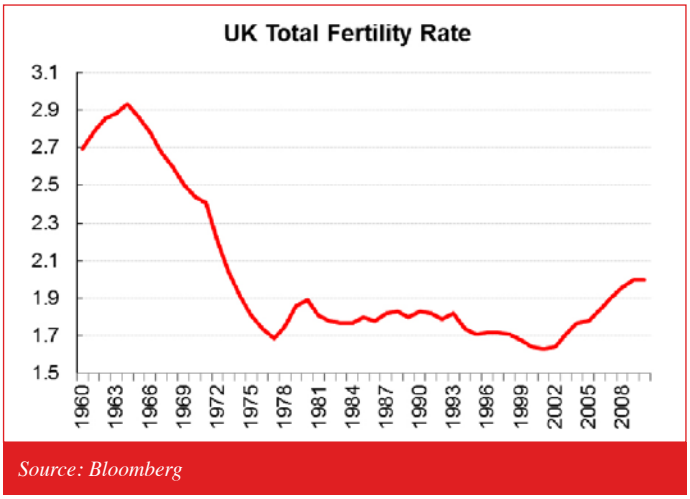

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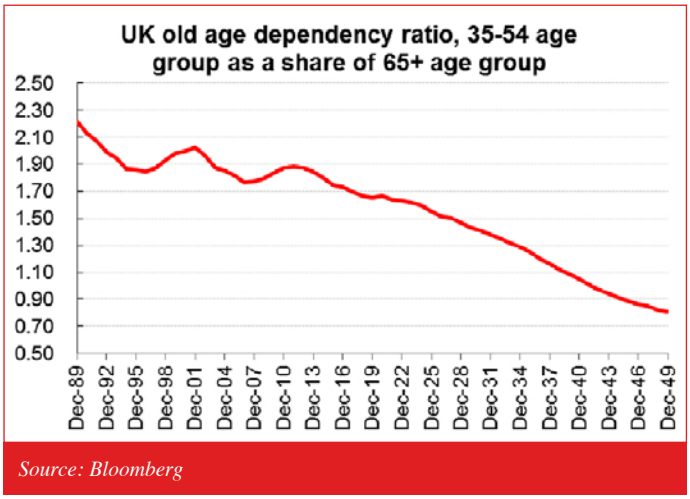

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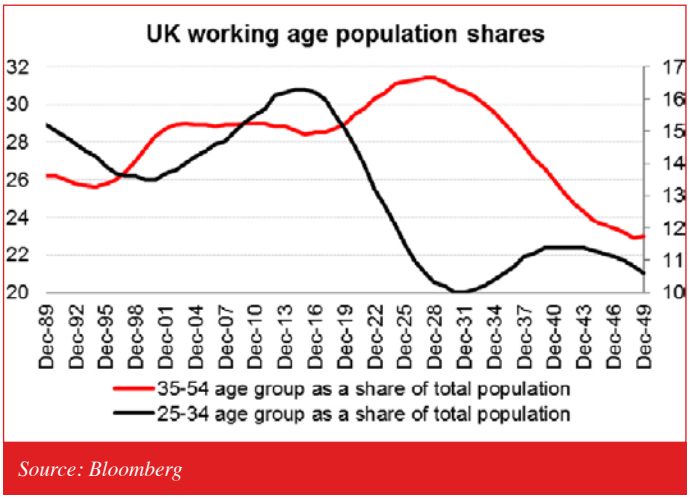


Source: Bloomberg

DEMOGRAPHICS AND DEBT

Compared to other developed economies the demographics of the UK are more balanced. Fertility never fell to below 1.5 children per woman and seems to have recovered back to replacement levels in the last decade. Still, a rapid fertility transition which began in the 1960s/1970s and which further gained traction in the 1990s coupled with an increasing level of life expectancy for both sexes means that the UK economy is going to age considerably over the next 20-30 years.

The ageing of the UK population is mainly a problem in relation to the ongoing excess expenditure of the government and the promises of future healthcare and pensions. The UK workforce is ageing and needs to support an ever higher share of elderly who are not working.

The problem in the UK is principally the same as all other developed economies face:

- On any realistic measure the burden of future liabilities (pension, healthcare etc) outweigh future assets and thus the ability to service these liabilities by a significant margin.

- Systematic deficit spending and build-up of debt means that too much have already been borrowed from the future and the scope for spending more today at the expense of the future is no longer present.

In the UK, 85% and 90% of a given male and female cohort can now expect to live until they are 65 which means that almost all workers at some point will become "dependent" in the future. This dependence may then come to rely on their assets and savings or on the government's ability to support them. The difference here is semantics. No matter who ends up supporting those who do not work the ability to do so depends on your actions today. Only by saving today, either as a society or as an individual, will you be able to consume tomorrow.

The real and naked truth in this regard is that instead of saving for a future of fewer income earners relative to retired workers, the UK (and other countries) have instead borrowed in spectacular fashion. Spending today what you do not have invariably borrows from the future and in a cynical sense the unprecedented expansion of credit has merely reflected the financial system's rational response to a desire for consumption today relative to tomorrow.

However, it is unlikely and even impossible that this situation can continue and to make matters worse, the payback is coming at a time when the economy's ability to service a high level of debt is going to be in a structural decline.

The impact on the structural deficit is marked. Unfunded liabilities in the form of pensions and healthcare will be highly problematic for fiscal sustainability.

UK HOUSING AND DEMOGRAPHICS

Two obvious questions pose themselves straight away from the point of view of long-term housing in the UK:

Will demographics provide tail- or headwinds to the housing market and how will future generations' total wealth be affected by housing?

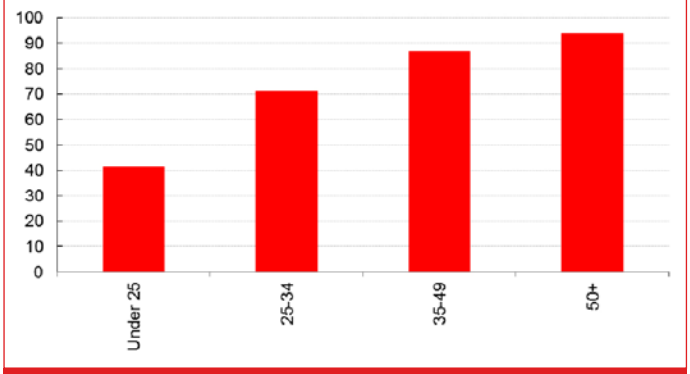
In the specific context of the UK, ageing will move more slowly than in the rest of Europe mainly due to higher fertility rates in the UK . This is a plus for housing in the long run. However, as the UK economy ages and as the workforce matures, the demand for additional housing will inevitably wane. The best way to think about this that the velocity of housing demand will go down with population ageing; in the future, there will be more households in the UK who already own a house (and who are likely to stay) than there will be new households with a demand for new (and bigger) houses. Two points are worth highlighting in particular.

- Older households are less mobile but also less liable to trade up in terms of housing. This adds to a lower velocity of housing demand.

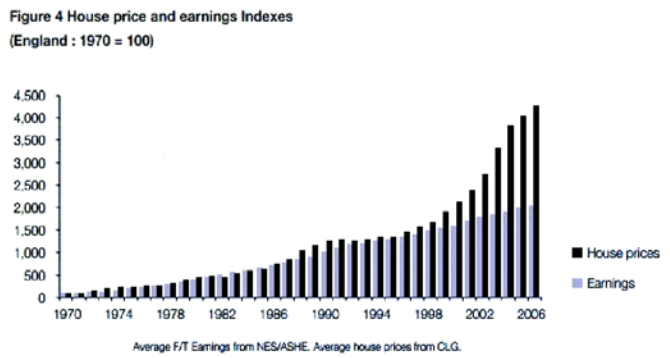
- Older households are less likely or able to take on debt to buy a dwelling.

These two arguments follow a very simple life-course framework in which housing investment represent a considerable amount of total investment over a household's life time. As such investment cannot, on average, be done without taking on debt it must be undertaken at a time when there is a reasonable chance for the household to be able to pay back the debt over the course of its income earning years.

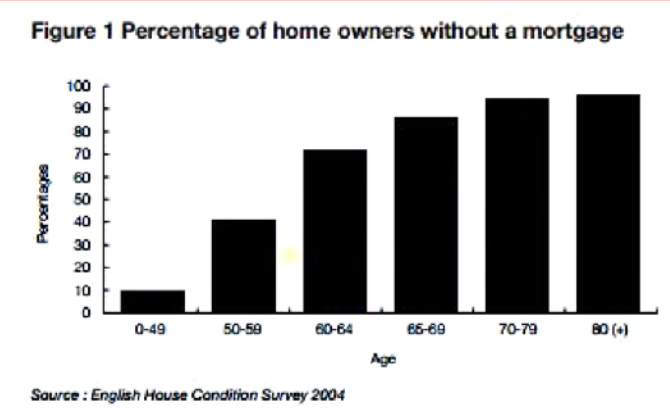
[3] *Indeed, this is the case in all the other Anglo-Saxon economies too; Ireland, Australia, the US and New Zealand.*



Source: rics.org, April 2009



Source: rics.org, April 2009



Source: rics.org, April 2009

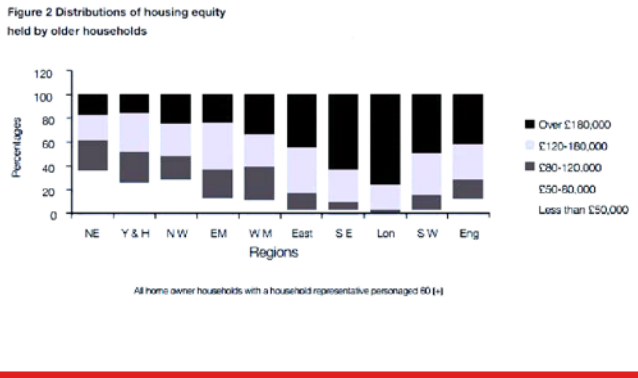
In addition to the point above, the structure of the housing market will change as the population ages, but it is very unlikely that the UK will experience a crash in housing due to the demographics. Even in extremely old countries such as Japan, housing does not crash but merely fade as an important contributor to macroeconomic activity. **This absence of housing and real estate as a wealth driver may in fact be the most important effect in the UK and other OECD economies.** A lot of hopes are still pinned on the ability of a succession of generations of young households to rely on housing and real estate as a store of wealth (and future consumption), but the demographics of a developed economy tell us that this is likely to be a false hope.

This is true even if we disregard the more obvious driver of a weaker housing market in the form of continuously overpriced housing and real estate in nominal terms due to a credit bubble.

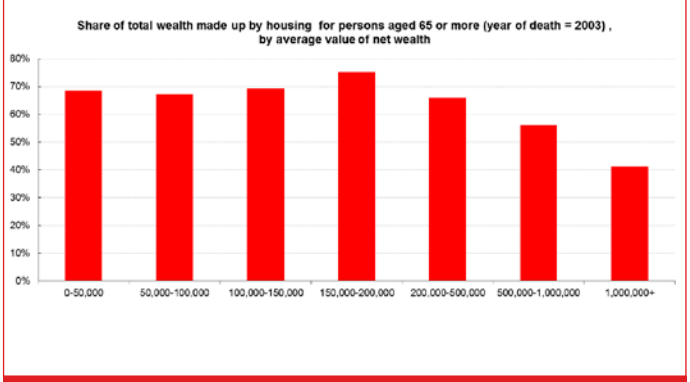
The main evidence for the hypothesis of a lower velocity of housing demand and not a housing crash in the UK as a function of demographics can be found in the chart below.

The chart shows the share of UK households reporting the same address as a year ago as a function of age. The data is taken from the 2001 census and clearly shows that once the household reaches the 35-49 age bracket (based on household head) more than 80% reports the same address as a year ago. This does not mean, obviously, that such households are inherently immobile, but this chart shows the logical consequence of households making their main housing investment while they are in the 30-45 age bracket (roughly speaking).

The most striking difference in the UK however with respect to housing is the role housing has played so far as a store of wealth for the UK population.



Source: rics.org, April 2009



Source: rics.org August 2009, HMRC

Since 1970, UK house prices have risen almost without reprieve. Together with the chart to the right this shows how older households are largely without mortgages, and thus translates into substantial net positive equity position in housing for elderly households in the UK. They have not only managed to pay down their mortgages, but also built up considerable equity positions in housing.

For a young household buying today perhaps even on an interest only basis, it is very unlikely that it will be able to build up the same kind of equity over its life time as the previous generations have been able to.

A fascinating data point comes from looking at the figures for identified net personal wealth of persons aged 65 or more who died in 2003 (data collected by the HMRC Inland Revenue Statistics). The average value of net wealth of all people surveyed was £213,060 of which 67% (£143,970) was made up of real estate wealth/equity at time of death. The remaining 33% (£69,090) was financial assets.

For persons with more than £200,000 net wealth the share of housing drops off a bit as such households tend to hold a larger share of wealth in financial assets. For persons with substantial net wealth (more than a £1,000,000) the share of housing drops below 50%, no doubt due to outliers in this category with substantial wealth parked in financial assets.

Still the key point is that for all but the most affluent persons in the UK aged more than 65 (who died in 2003) more than 50% of their net wealth was made up of housing at time of death. This is a staggering figure and shows how the old generation has benefitted hugely from the run-up in house prices in the past 3 decades.

The key premise we have for this report is that the young generation cannot expect their net wealth to be buoyed by housing to anywhere near the same extent. In general, in the UK the wealth effect from equity in one's house is significant as we have a nearly 70% ownership of housing and almost 50% of a household's assets are in their house. So if housing falls so does both the equity and potentially the income of UK households.

Anything that upsets the mortgage rates has the potential to cause a severe depression in the UK as already stretched incomes will become unable to service household debts. Although we have illustrated there are structural issues impacting the mortgage market and the ability for homeowner's to manage their debt, we believe mortgage rates are at the mercy of an exogenous shock – that of a capital flight from the UK gilts (and banks). We will expand on our reasoning in the next section.

STERLING MESS

Our overriding premise is that the UK will experience a precipitous fall in the value of sterling. This could arise as a function of expectations of fiscal difficulties, BoE QE impact and or by capital flight from UK gilts and hence sterling, as the fear of default from fiscal incontinence gets brought forward. This is a precedent we have witnessed in Italy and Spain, except that they don't have their own currency.

Foreign investors would want to be compensated for inflation and default risks with both lower sterling values and higher bond rates. In truth a buyers' strike would see bond rates soar to levels that entail heightened fiscal unsustainability overnight; a clear case of falling over the fiscal cliff. This is clearly not an eventuality that markets are assigning any probability.

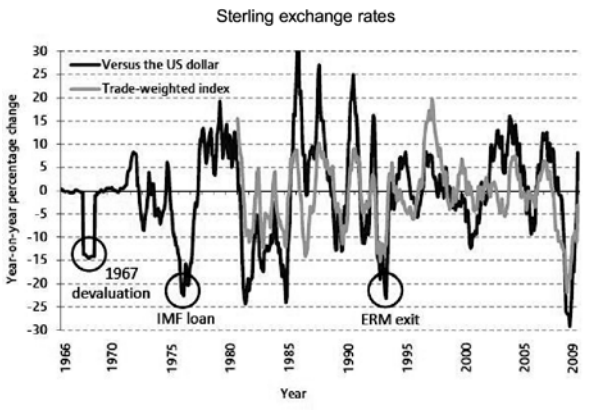
Sterling and gilts have maintained a 'safe haven' status in a 'sea of relativity'. The UK government had the luxury of watching their union partners come under fiscal scrutiny and subsequent cries for austerity first. They moved swiftly to jawbone on aggressive austerity measures of their own – a reduction in spending and tax hikes to help reduce the fiscal gap and long-term structural UK public debt. The IMF and OECD responded to such moves endorsing the UK's declaration of deficit reduction, providing independent support for the UK's fiscal situation.

But we have illustrated that the reduction in debt has not occurred. It is at best an illusion, at worst a lie. The need for government propaganda saying otherwise is obvious enough, of course; rises in market interest rates could cause incalculable economic misery, given the extent to which British households are leveraged. Likewise implementing the real cuts required to back up a genuine austerity package have proved politically unpalatable, as the private sector has not been able to take up the slack in employment that is entailed when public sector employment will need to be reduced.

The UK government is fast approaching the moment when investors, especially overseas investors (and ratings agencies) finally see through the spin and call in to question the sustainability of the UK's public finances. This leaves a question mark over the risk of a sharp drop in sterling.

Currency devaluations or crises are often associated with fiscal crises. A negative debt dynamic will ensue in the UK as overseas investors will be rightly concerned about the value of their gilt (sterling) holdings. A drying up of foreign capital is a very real threat. Guillermo Calvo, an Argentinean economist coined the term 'sudden stop' to describe the abrupt halt of capital in to an economy. We only have to point to the European periphery as a recent example of such behaviour, as periphery debt yields rose dramatically as capital exited overnight.

The 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.



Sources: IFS Green Budget February 2010

The UK is not as different from the European periphery it may like to think. The main difference is that the UK is not going to be choked by the rigidity of the euro. A single currency union is akin to a peg as it 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 produced. This inflicts untold hardship on these countries populations.

The UK can undergo currency 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.

Our real fear is that a sterling crisis could well occur more as a function of a fiscal crisis and the subsequent capital flight from the gilt market than the value of the sterling falling to compensate for a perceived heightened risk of this eventuality. **We are saying it could be a reality not an eventuality.**

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 one every 15 years.

The 2008/09 sterling fall although a 25% decline was largely due to the demand for dollars from debt deflation that swept the globe and impacted all currency pairs to the dollar. This next sterling crisis will be that of sterling itself. No foreign nation needs to own sterling and this is especially so with excessive global sovereign debt nations 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 choices 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.

HOUSING WEALTH COLLAPSE AND INCOME FALL OUT

If there is a flight from gilts, then the impact on mortgage rates could be catastrophic banks would be under severe duress and need of capital, so lending conditions will tighten and mortgage rates would rise. Individuals would not be able to service their debt and defaults would rise. Now clearly a collapse in bond prices would also undermine bank equity as their capital base would be destroyed by falling gilt prices which help capitalise them and the double whammy of loan impairments from the housing sector.

The BoE would respond with 'emergency measures' and the government would call for help from the IMF, US and Europe. The last time we faced this ignominy was when the labour Chancellor had to go 'cap in hand' to the IMF for a £2.3 bn loan, and that was before public spending cuts were enforced. The UK can only dream of such a low borrowing need.

Unfortunately with the globe swathed in debt itself, we are afraid it's very much everyman for himself.

A sterling collapse and BoE printing would ensure that prices would rise from both imports and domestic price inputs. Today, a fiscal crisis will not be alleviated by a fall in sterling and rates would need to be lowered not raised so as not to shut the credit mechanism, but once the market leaves the gilt market, rates will rise.

If the current market yields rise above the economy's trend rate of growth the public debt ratios will rise exponentially. Our assessment of growth is that it will not achieve the average 2.8% required over the next decade to offset this eventuality.

Of course, such loss of capital funding for the UK will only escalate the real risk of domestic directives forcing financial institutions to hold more domestic debt. We may even see the introduction of capital controls to prevent domestic capital fleeing overseas. We would note desperate times lead to desperate measures. As investors and UK citizens we need to maintain freedom over our capital - one such asset that facilitates this is gold.

THE END SOLUTION

Prime Minister David Cameron announced that the Office of National Statistics (ONS) would start measuring Britain's wellbeing from April 2011, in order to allow the Government to promote quality of life as well as economic growth:

"From April next year we will start measuring our progress as a country not just by how our economy is growing, but by how our lives are improving, not just by our standard of living, but by our quality of life. We'll continue to measure GDP as we've always done, but it is high time we admitted that, taken on its own, GDP is an incomplete way of measuring a country's progress."

The ONS has opened a consultation on its measurement of national wellbeing, inviting views on the development of new measures to "cover the quality of life of people in the UK, environmental and sustainability issues, as well as the economic performance of the country."

The ONS suggests a number of aspects known to affect wellbeing:

- Income and wealth;
- Job satisfaction and economic security;
- Ability to have a say on local and national issues;
- Having good connections with friends and relatives;
- Present and future conditions of the environment;
- Crime;
- Health;
- Education and training;
- Personal and cultural activities, including caring and volunteering.

Commendable as this is, we can constructively respond to all areas of this survey by saying that by and large the UK's wellbeing is pretty rubbish. Cameron may have read Oliver James's Britain on the Couch, but barring prescribing liberal amounts of pure MDMA to boost serotonin levels, we may all be better off taking liberal doses of ketamine. Perhaps the youth of the day have got it right.

We do hope though to offer some more constructive solutions. Drugs, like money printing and low interest rates, merely offer momentary release from our problems. Like drugs, as the effects begin to wear off, the outstanding issues we have masked come back with a heightened vengeance. Unfortunately, continued liberal sprinkling of money will have to be bigger and bigger as its marginal utility lessens.

MONETARY REFORM BEGETS POLITICAL REFORM

We believe that to offer a long-term solution to the UK economy we need monetary reform which will instigate meaningful political reform, by limiting the impact of the State in the economy as the issuance of money is returned to the free market under an independent judicial system.

In offering solutions we would advocate the tenets of the Cobden centre. It was founded in the spirit of the philosophies espoused by the 19th century British manufacturer, and classical-liberal thinker who became MP for Stockport, near Manchester. His beliefs in free trade, as exemplified by his implementation of anti-protectionist legislation of the Anti-Corn Law League, are the cornerstone of modern economic society today. He was a true libertarian.

COBDEN'S LAW

The Cobden Centre (TCC) was established to promote social progress through honest money, free trade and peace. We would thoroughly support their vision articulated here:

"Our vision is of a peaceful, open and free society based on a stable, sustainable economy in which everyone has the opportunity to participate in constantly growing real prosperity."

Based on sound scholarship, (primarily the Austrian School) they argue that such a society must be built on honest money; of which we at Hinde are advocates.

Honest money means an end to credit expansion and false booms followed by financial crises with appalling human cost. It means an end to inflation of the money supply and hence prices. Honest money is the key to social progress in the 21st century.

Therefore:

- TCC believe that social progress comes when private property is secure and all people enjoy an increase in their real income. They believe that the reduction of relative poverty and the increase of general prosperity will make society more orderly, stable and free.

- TCC believe that, today, the first condition to secure private property, to diminish widening wealth inequality and to establish a stable, sustainable economy for the benefit of all is honest money.

- TCC believe that the method of increasing real income for all people is a social system of independence, interdependence and mutual cooperation: the free market.

TCC believe, with Richard Cobden, that with honest money and free trade, international peace and social progress will follow. We also endorse Cobden's view that:

"Peace will come to earth when the people have more to do with each other and governments less."

We would dryly note that Cobden's law should not be mistaken with Coughlin's Law – 'Bury the dead, they stink up the place', which is a very a propos analogy for how most advanced countries are trying to bury their debt and ailing assets under the veiled legality of QE and financial repression.

In October 2010 the BoE Governor, Mervyn King, made a big intervention into the debate on banking reform. In a speech at Buttonwood, New York, he listed some radical proposals for the Independent Commission on Banking to review:

- Forcing the riskiest banks to hold capital "several times the magnitude" of requirements at present.
- The Volcker rule-style enforced breakup of banks into speculative and non-speculative arms.
- The "Kotlikoff proposal", which forces banks to match each pool of risks with a requisite amount of capital, preventing losses in one spilling over into another.
- Stunningly, Mervyn King imagines the "abolition of fractional reserve banking"

"Eliminating fractional reserve banking explicitly recognises that the pretence that risk-free deposits can be supported by risky assets is alchemy. If there is a need for genuinely safe deposits the only way they can be provided, while ensuring costs and benefits are fully aligned, is to insist such deposits do not co-exist with risky assets."

It is encouraging that a central banker, although recognising that such radical reforms should not be implemented overnight, does believe they are a better long-term solution to preventing banking crises; especially those borne out of boom bust cycles.

We would promote a free banking system, one with no central bank monopoly of money, but one where the rule of law resides over private banking. It is probable that commodity money such as gold is economically inefficient but it is trustworthy and honest; whereas fiat money production is monopolistic and open to transgressions (abuse) by government and a weak central bank. Encrypted electronic cash, backed by gold may well come to rival fiat currency systems especially with the rise of mobile payment systems under private enterprise.

A thoughtful piece on limiting fractional reserve banking is given by Toby Baxendale, an Austrian scholar, an accomplished entrepreneur and Chairman of TCC: A day of reckoning: how to end the banking crisis now. This is one of ten plans cited for financial reform, by the Cobden Centre staff, fellows and board members who span academia, finance and politics – 'Ten Plans for Financial Reform'.

The objections to limited banking or 100% reserve-banking are covered and although not a definitive they really begin the debate that should never had to occur ie who does your money belong to when on deposit at the bank. Give you a hint – it is not yours. By addressing this basic 'property' right we would be beginning the 'road to economic freedom', such reform would enable a return to prosperity that is more stable and far reaching and less prone to boom-bust cycles. Although we acknowledge that nature has cycles, they need not be as excessive as the cycles created by credit expansion and contraction.

FRACTIOUS BANKING

At present we have a banking system that exists within the framework of the central bank, which promotes monetary inflation and the destruction of the process of real wealth generation through fractional reserve banking. In this system the more unrestricted the banks are the more money out of "thin air" (shadow banking) can be generated and hence greater damage is inflicted upon the wealth generation process. This must be contrasted with genuine free banking, ie the absence of the central bank, where the potential for the creation of money out of thin air is minimal.

For some time we had to get our head around the idea that banks should be regulated to prevent them creating excessive credit, as this would conflict our desire to maintain free markets. Murray Rothbard supplied us the answer to our conundrum:

"Many free–market advocates wonder: why is it that I am champion of free markets, privatization, and deregulation everywhere else, but not in the banking system? The answer should now be clear: Banking is not a legitimate industry, providing legitimate service, so long as it continues to be a system of fractional-reserve banking: that is, the fraudulent making of contracts that it is impossible to honour."

As Dr Frank Shostak puts it, it was the introduction of financial de-regulation and the dismantling of the Glass–Steagall Act in the 1980s that resulted in fierce competition between banks. The previously fixed margins were severely curtailed. This in turn called for an increase in volumes of lending in order to maintain the level of profits.

In the present central banking framework this increase culminated in an explosion in the creation of credit out of thin air – a massive explosion in the money supply. In the deregulated environment, banks' ability to amplify Fed's pumping has enormously increased.

SOLVENTS

Reality or cynicism - in the near term we do not believe there are any quick or sure fire remedies that would prevent the UK from coming under greater fiscal scrutiny. The free markets, if we can call them that, will likely execute a damning appraisal of the UK debt dynamics as we outlined. So it is most likely that long lasting reform cannot be implemented soon enough to effect change in the next few years.

Also a change from fractional reserve banking to 'limited' reserve banking would affect substantial near term damage on a financial system that's capital structure is propped up on leverage and preferential tax treatment of such leverage.

We would note that regulatory oversight is meaningless until we have demarcation of retail and investment banking. We constantly tell our clients that we are regulated by the FSA, as if this gives us some credibility. In truth it is as meaningless as it was in the case of MF Global, who were permitted, just as other brokers have been, to rehypothecate (gamble) with segregated client money. We at least hold most of our assets in allocated physical gold, which is a form of limited deposit banking.

WEALTH OF A NATION, THE UK

When writing this piece we came across Mckinsey's consultancy piece on the UK, called appropriately "From austerity to prosperity: Seven priorities for the long term". Disappointingly it doesn't address the fundamental issue that the UK needs monetary reform but it does address how growth could be obtained. The tenets of their piece follow largely those we spelt out in our Wealth of Nation – HindeSight Letter April 2012; here is an excerpt from our letter:

In their book Why Nations Fail: The Origins of Power, Prosperity and Poverty they illustrate historically and contemporaneously how nations sustain prosperity by encouraging an openness of society, willingness to permit creative destruction and democratic rule of law. It is the relationship between man-made economic and political institutions that fosters these aspects of the nation. Those institutions that promote real growth through productivity enhancement and encourage progressive innovation will thrive, as opposed to those that move towards repressive institutions of the State will stagnate and fail.

The cornerstone of any nation developing its primary resources to maintain wealth has largely been held to be due to labour productivity, which in turn is driven by the interaction of these factors:

1. **Quality of human capital, well-educated and flexible**

2. **Innovation and ability to move up value chain, (technical training, and growing R&D)**

3. **Strong core physical infrastructure maintained by high gross capital formation**

4. **Flexible and transparent business climate, with regulatory and legal transparency**

5. **Favourable demographics**

6. **Economic Freedom:**

   - **Rule of Law** (property rights, freedom from corruption);
   - **Limited government** (fiscal freedom, government spending);
   - **Regulatory efficiency** (business, labour and monetary freedom); and
   - **Open markets** (trade, investment and financial freedom).

The UK needs to adhere to these areas and it needs to reduce the impact of the State, which has created an overwhelming sense of entitlement through an over-inclusive welfare system. 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 social divide has increased most in the UK than any other OECD country as we have depicted in the section – A Nation Divided.

As the sociologist Erich Fromm would have put it, we have moved from a state of "being" to a state of "having". Now we are obsessed with what other people think of us, and we've lost touch with our own feelings.

We offer some ideas, not definitive or exhaustive for promotion of prosperity or enhancement of the 'Wealth of Our Nation'.

Key policy recommendations for addressing Inequality:

To reduce the social divide one needs to reduce the welfare state.

- Employment is the most promising way of tackling inequality. The biggest challenge is creating more and better jobs that offer good career prospects and a real chance for people to escape poverty. We need to encourage small business enterprises and make it easy to employ as well as let unproductive workers go .

- Investing in human capital is key. This must begin from early childhood and be sustained through compulsory education. Once the transition from school to work has been accomplished, there must be sufficient incentives for workers and employers to invest in skills throughout the working life. Vocational education should be encouraged and given equal emphasis.

- Reform tax and reduce the size of the welfare state. The benefit system is the most direct instrument for increasing redistributive effects. Large and persistent losses in low-income groups following recessions underline the importance of government transfers and well-conceived income-support policies. However, benefits should be altered so as to provide a minimum safety-net and encourage vocational job skills. Giving payment for such training also gives individuals a sense of purpose and meaning rather than a sense of hopelessness.

  (If we move to our vision of a sound monetary system this would allow the UK to easily reform taxation and make more streamline. For income we would then advocate a flat tax. We believe this would encourage entrepreneurship. Our income and savings should be equally taxed, to meet services and minimum welfare needs. In effect entrepreneurs would be rewarded for the creation of real savings through production.)

- The growing share of income going to top earners means that this group now has a greater capacity to pay taxes. It will be tempting for governments to further increase the progressiveness of the tax system to capture a larger share of wealthier individual's tax gain. But this would be wrong.

  (Unfortunately in a fiat currency system, individuals who build and more importantly receive money first (government and associated entities) will accumulate assets which will inflate in price before others receive money. Such entities grow rich at expense of others. It's not a meritocracy. Occupy Wall Street are right to be angry but they have not comprehended the extent of monetary enrichment. Lobbyists and cronyism is a by-product of a corrupted monetary system. If you can get policy directives changed to promote your business sector you know the money will be readily available, likewise you can employ borrowed earnings to 'buy' your cause.)

- Entrepreneurship does not exclude individuals who provide services for the community, nurses, fireman etc. Far from it. Social reforms could encourage community ownership of hospitals, social amenities, along the lines of 'friendly societies'. Welfare support can be provided by the private community. We would advocate a move to welfare without the state or at least greatly reduced state involvement.

- The provision of freely accessible and high-quality public services, such as education, health, and family care, is important; but one that is created and owned by the community. A form of mutualisation or stakeholder interest. The people own the services not the State.

  Friendly Societies or mutual organisations can be instated for a number of community businesses including insurance and savings banks (regional or even national).

- Aging demographics needs to be addressed. A lot of equity is in housing for the elderly, perhaps using reverse mortgages they can take out prudent amounts of equity to fund themselves or the next generation; thereby alleviating welfare payments.

Key policy recommendations for creating prosperity:

UK needs to contain its public debt whilst encouraging private-sector investment, which will enable growth.

Our tax system suffers from over-burdensome red tape, according to the 2020 Tax Commission, the Tolley's Tax Guide (complete version) was 11,520 pages long in 2009, more than double the 1997 figure. We would note War and Peace is 1,204 pages. You get the picture.

We agree with the 2020 Tax commission (www.2020tax.org) on their main premises:

"The reality is that families and businesses in the UK are still taxed far too much. The UK has the world's longest tax code – which has more than doubled in the last 13 years – and the costs of administering this system have soared at the same time."

"For too long policy in a variety of areas, from welfare to business support, has seen the Government tax people and businesses too much and then hand some of it back as tax credits or grants. The VAT hike has come in, as well as fuel duty; the level of employers' National Insurance Contributions offers weak incentives for employers to hire more staff and grow their business; hard-working families have less of their own money in their pockets and even face substantial taxes when they die; the complexity of the tax system means that mistakes are all too common."

The point is to have a structural overhaul of the tax system to make it simpler. Introduction of flat taxes are not regressive they arguably promote meritocracy especially when introduced into a society that reduces its reliance on the welfare state and even creates its own 'privatised' community welfare.

Some 80 years ago, Lord Clyde, President of the Court of Session, ruled:

"No man in the country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or property as to enable the Inland Revenue to put the largest possible shovel in his stores. The Inland Revenue is not slow, and quite rightly, to take every advantage which is open to it under the Taxing Statutes for the purposes of depleting the taxpayer's pocket. And the taxpayer is in like manner entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Inland Revenue."

- Tax reform to encourage business investment environment in the UK, and growth of medium-sized enterprises. Corporation tax has been lowered but we are still less competitive than most.

- Encourage more Richard Bransons – more entrepreneurs and this starts in the classroom.

- Reduce regulation of multinationals. Work with them to encourage them to make long-term investment in the UK. This means controlled but open immigration.

- Improve technology gap by encouraging tax efficient schemes for private enterprises to invest in start-ups and mid-sized firms. This does not mean preferential taxation on private equity groups using loopholes in accounting.

- We need to rebuild our energy infrastructure – encourage investment in exploration, efficiency of usage and production. This has been encouraged.

- We need to rebuild our transport infrastructure. We invite private and overseas investment by providing attractive taxation in return for domestic employment of qualified workers and training of UK workers; but they are subject to usual employment law not a quota system that enforces employment.

- UK health industry needs to migrate to private and community ownership.

- Pension reform and protection of workers' rights need to be addressed. They have become tooinflexible and a drag on efficiency of businesses.

- We should develop healthcare in conjunction with revenue from bioscience and pharmaceutical-industry that is growing here based on our expertise and education system.

For the UK financial system the solution is almost certainly some combination of better mechanisms, rules, and prudent business practices aimed at increasing the level of reserves and thus resilience, in the system in the short term. But in the medium term we need to completely overhaul the banking system. Excessive credit cannot be allowed to encourage individuals to create their entire prosperity out of house ownership. Rising prices is not a signal of wealth creation it is a symptom of the rise in credit from monetary expansion in a fiat currency system.

Growth is the best answer to excessive sovereign debt but this is merely wishful thinking at this stage in the debt cycle. The best way to have sustainable growth and hence wealth is not to have so much debt in the first place. If the money supply is stable then prices will be stable and productivity will provide cheaper priced goods. Our purchasing power will go up in tandem.

ALL OUR POMP OF YESTERDAY
Cameron needs to have his Thatcher Moment.

Cameron needs to get radical - he needs to offer hope where it is diminishing not only by the week but by the hour. But the Coalition is creating an impasse.

We can't help but sense that the handing over the Olympic torch in Greece to Britain was more symbolic of the passing of economic woes. We wish it were not, but we cannot stand by and walk with our Eyes Wide Shut. It is our fiduciary responsibility both as an investment management firm to protect our clients' wealth whilst it is our right as free citizens to help maintain the democratic landscape by offering solutions on first monetary and political reforms, some of which we have highlighted in this letter.

EPILOGUE

Today Great Britain still holds a pre-eminent place in the economic and geopolitical landscape of the 21st century; and today it arguably still holds a key foothold in international politics as well as remaining the 7th largest economy in the world. But how sustainable is this?

Britain rose to power on the crest of the Industrial Revolution, and no empire has been larger or more diverse than the British Empire. At its zenith in the 1930s, over 42 million Britons governed some 500 million subjects. Britannia truly ruled the waves and over a quarter of the earth's surface was painted pink on the map. Yet as quick as she came, she faded even faster. What took three generations to build was gone in one, often amid tremendous bloodshed and misery. Britain has a ghost of an empire, a rescinding Commonwealth of sea-girt dependencies, and one now skirt tailing a failing US Imperialism. The Empire left at best a legal code, a universal language and sporting endeavours, but at worst it has left failed and feuding states.

The cornerstone of a country's wealth need not be determined by its geographical and economic expanse, but by its legal and institutional framework. Notwithstanding autarchic wealth, if a nation has a legal system which encourages the 'rule of law', an independent judiciary, limited government, regulatory efficiency and open markets then a country is highly likely to prosper with less inequality across the nation.

The rule of law is one that protects private property rights and freedom of exchange. The judiciary is one that is independent of influence from centralised executive and legislative branches as well as government. So in this sense it tolerates minimum corruption that can come hand in hand with such influence. This means limited government and a nation which is highly supportive of business so that regulation is light-touch and doesn't stifle the prospects of business growth and development. And finally this is only enhanced by the encouragement of open market behaviour within this institutional framework so that there are low barriers to entry in terms of competition in all areas of the private sector economy - trade, investment and finance.

Courtesy of massive public borrowing and low interest rates the public has been highly shielded from the pain of recession. Touching on the concepts introduced in last month's Investor letter, Wealth of a Nation, **we perceive the UK's 'wealth' to be highly endangered, because its pillars of economic freedom are under threat from excessive indebtedness.**

This indebtedness manifests itself from an over inclusive welfare state, and a nation that persists in defining itself by too much emphasis on expressing its wealth by house ownership. To recall from our last letter it is our consideration that the credit cycle is the primary driver of long term business cycles which are inherently entwined with property cycle boom and busts. The UK is a shining example of this.

Economic freedom is the key to the long lasting 'wealth of a nation'. All other aspects of society will thrive if a nation adheres to this ideal. Unfortunately, as we have demonstrated, excessive imbalances in property cycles have accelerated this loss of freedom in the UK. **Property cycles propagated by credit availability, the use of property as collateral, and Western nations' institutional aversion to countenance deleveraging in the economic system have amplified swings in long-term economic (business) cycles.**

We have explored how the UK, saturated in debt, has a stark choice should it wish to prosper in the future, or fail. **Unfortunately, we believe that a nation will tend to bankrupt its citizens before it bankrupts itself;** especially under fiat currency systems when they have the temptation to fund a welfare state through continued deficit financing. This is the case in the UK today. So until such time as we have monetary and political reform in the UK, one's purchasing power and civil liberties will become ever diminished.

And yes the cynics amongst you will not be surprised to know we would recommend gold in your portfolio as a means to protecting oneself against such loss of economic freedom. Of course we would recommend Hinde Gold Fund, because we offer an allocation to physical gold accompanied with returns in excess of the gold bullion price in USD, EUR or GBP. And we aim to continue to do so. **We would of course be delighted to close the Fund should gold become part of the monetary system again, but until such time a varying, but never insignificant – or zero – percentage of one's portfolio should be always be held in physical gold.**