

# Philip Manduca

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**Philip Manduca**  
ECU's Head of Investment



## Introduction

Good evening – before I give you my thoughts on the future, please allow me to introduce myself to those of who you were not here last year. I work for The ECU Group plc in London, which is over 21 years old. We are a multi-currency liability manager, which in simple language means we aim to reduce debt through the use of investments in the currency markets. Our record over the last 21 years has shown debt reduction of over 80%. We also manage assets specialising in currency and macroeconomic investment products supported by strong track records of performance and extensive experience.

## The world economic situation

I promise to try not to spoil your enjoyment of a very pleasant evening – but it might be hard to do.

A year ago when I spoke here, I stated that: "You may be tempted to conclude that recent economic and stock market strength means we are returning to either 'business as usual' or something that looks pretty familiar. That would be completely the wrong conclusion to make. The threat of systemic failure has faded, but the crisis hasn't. Indeed, the debt crisis is now only at the end of the beginning phase, and has a long way to run.

"We are in the early stages of a generational shift in the balance of global economic power. The combination of a massive debt burden, the legacy of over-consumption of recent years, a lack of 'once in a generation' technological innovation and the excessive capitalism of policy-makers has combined with a shift of economic power from the so-called developed western economies to China, India and Brazil. This means that you will not – before you die – see a return to the levels of wealth and economic activity that you have enjoyed in recent years. I am certain of this".

I also suggested that gold would be an optimal investment, and expected it to reach \$2,000 sometime this year. I still do and I will discuss gold later on.

So, it is a year since I last spoke to you and I am still not convinced that enough people understand that this is not a case of just surviving the present debt crisis until things improve. Economic fundamentals are worsening all around you as sentiment artificially attempts to recover. Massive additional debt has had to be incurred and had to combine with zero interest rates just to generate flat growth in Europe and stave off massive real estate collapses in Japan, the UK and the US. Consumption remains anaemic, income growth stagnant and savings are increasing but only because everyone fears for their jobs. We remain in big trouble, and banks and debtors need to work closely together in a dynamic fashion to avoid complete economic collapse. But can the banks sit back and hope for recovery? I don't think so. For some time, banks have been engaging profitably in non-banking businesses such as trading in credit and derivative markets which have now imploded on them. They already have too many write-downs ahead of them to support the corporate sector with loans, and are avoiding putting realistic valuations on effectively redundant debt in the vain hope that it will somehow either be repaid or the underlying collateral appreciate in the future. Banks need to provide and receive long term solutions to and from their clients.

## First response

In 2009, the first reaction of policy-makers was to impose new rules, blame bankers and the bonus system, and generally deflect blame away from their own mismanagement. I don't want to be too critical, because they also stepped in very quickly with huge rescue packages in 2009, injecting public money to make sure that we didn't see a repeat of the 1930s. That was a major success, even if the bill is now both shockingly large and increasing.

The policy-makers' second reaction has been even more radical. Faced with a frozen banking system that cannot lend, frightened consumers and businesses who don't want to borrow, and rising public debt to refinance, they have adopted a policy of unprecedented monetary deflation.

Without going too deeply into economics, there are two drivers behind this gamble. The first is the need to counter the collapse in the velocity of money – the speed at which the existing money is moving around any economy. The second is the fact that a sustainable debt path for an economy requires that the interest cost on the nation's debt must be lower than the nominal growth rate of the economy if the real value of the debt is going to be kept constant or falling.

Policy-makers can't do anything about the collapse in the velocity of money. But they need the growth rate of nominal GDP to be faster than the growth rate of debt. The solution is Quantitative Easing: print money and buy debt, holding down bond yields, keeping the cost of refinancing low and increasing the amount of money in the economy so that growth can be re-started.

The price of doing this in the long term is to crush confidence in the underlying value of money, causing a fear of inflation and a collapsing currency. There is just so much slack in the global economy and so much excess capacity and excess labour around the world that inflation is not a threat – yet. And exchange rates are relative, not absolute prices. If all major central banks print money at the same time, none of them sees their currency collapse against each other.

I've dwelt on this reflationary and monetising policy because I think it's very important. Monetisation reflates asset prices, it makes financing these huge deficits possible. And it forces the strong, new economies around the world join in the reflation by pouring even more money into Treasuries, Bunds and other G7 assets to try to sustain their weak currency trade policies. But it will in due course force them to devalue their currencies. Some have allowed their currencies to rise – Australia and Brazil, for example. But the big target for the G7 economy is to force the Chinese to revalue the renminbi. We all know they will do so only at their own speed, but equally they will eventually do so if only to fight their own rising inflationary problems.

### Where does this lead us to?

Firstly, asset reflation may just work in the short term. The reason we have seen such a strong equity reaction to positive economic data in recent months is that few if any investors, speculators or analysts could imagine that the monetary response would be so ambitious (record low interest rates in the UK?), but it has been. The global economy is emerging from the most severe financial crisis in my lifetime and probably yours. GDP is back on a positive path and I would not rule out global growth registering a surprisingly strong continuation of recent strength in the next two quarters of 2010, particularly in the UK and the US. If I'm right and we are in a little window of economic recovery where asset inflation helps, job losses stop, equities continue to climb a wall of worry and confidence picks up, these fears may fade a little in the first half of 2010. But they will return as we move into 2011, with a vengeance.

Secondly, even if asset reflation doesn't work, you need to understand that there just is not a 'Plan B'. So, look for even more of 'Plan A' if the economy fails to respond mid-2010. A brief period of 'talking tough' in Q4 of 2009 triggered downward corrections in equity prices and hasn't been tried again. It won't be either.

Thirdly, politicians are not going to reverse course until reflation does work sustainably. This crisis was far too great, and the underlying inflationary trends far too subdued for any policy-maker to take chances with it. Unemployment remains too high and, in my opinion, reflects secular forces at play that will not disappear anytime soon. No one is reversing easy money soon, certainly not until inflation picks up and governments vacillate on how to rein in rising budget deficits.

When policy is eventually tightened, monetary policy will have to be tightened first as, with stubbornly high levels of unemployment, the political will to force fiscal pain on an electorate simply does not exist. The Bank of England will tighten before any other G7 central bank. The US will be politically paralysed by stubbornly high unemployment, and the ECB itself will bow to the very political originations of the

European Union and support crippled peripheral countries to maintain the union.

Fourthly, please don't confuse this asset reflation with a return to the world as we knew it.

### No going back

This gets me back to where I started tonight, that we aren't going to go back to the pre-2007 days. We will be more regulated, especially the banks, and we will not see credit expansion return to where it was. And we really are seeing a once-in-a-lifetime shift of economic power (though not yet of cultural, political, or military power) from the US and the rest of the G7, to the 'developing economies', whose demographics and cheap labour provide a strong stimulus to local growth and consumption.

What does all of this mean for you? If you want to make money – buy Gold, and buy large top quality diamonds and other hard assets. Economic growth driven by asset reflation and money supply is good for hard assets and bad for paper money. Buy freehold houses in Mayfair, or better still next to the lakes in Zurich and Geneva, all of which are in short supply. Buy equities of multinational companies with Asian consumer exposure hedged against equity indices. Economic growth, zero interest rates and reflation are all good for equities. They have rallied, but cheap money will continue to boost profits and this is still a very good way to take advantage of a global as opposed to a G7 economic recovery.

The US dollar's multi-year decline is not over, but the easy part of its fall is in the past. Interest rates won't rise significantly in the US and QE won't be reversed permanently anywhere, but US and UK short-term rates have troughed for the time being, the fiscal disunity in the eurozone and fiscal problems in the UK plays to pro-dollar themes of expanding government debt, widespread unemployment and a growing reliance on central banks to be the saviour of the economy. Japan remains mired in deflationary trouble. Only in the UK do I expect some respite in the short term, in a period over the next three to six months, when I expect both gold, the pound and the US dollar to strengthen simultaneously.

But do not be fooled – asset reflation will ultimately fail, either as deflationary forces prove too strong as in Japan for the last 15 years, or because it will boost inflation to intolerable levels and we will re-visit a version of the 1970s, with high inflation, rising interest rates and lots of public discontent as unemployment continues to increase in the absence of technical innovation creating a new industry of employment. You will notice that labour strike activity has already picked up in Europe.

### World domination

The US central bank's mandate is to achieve low and stable inflation subject to full employment. But full employment was previously only achieved at the expense of a huge trade deficit in a world where other countries were so much more efficient at producing the goods US consumers wanted to buy. That is no longer sustainable. The US and Europe need jobs growth to recover. The real unemployment rate in the US is closer to 20% and they need US demand to feed into US jobs. Not Chinese ones. The US wants – and needs – to force the Chinese and other faster-growing economies to revalue their currencies: either through inflation and higher

interest rates or directly through an official revaluation of their currencies. Put simply, the US experiment of subsidising the growth policies of the emerging world to create democracy, prosperity and peace has now ended, and ended with the effective bankruptcy of the US. They now want a return on their investment, measured by being able to sell their own goods back into the emerged economies. They will pursue every means possible to achieve this in the next few years or retaliate if they are obstructed.

The US will threaten protectionist measures throughout this year and accentuating into 2011 until they get their way. That will increasingly annoy the Europeans, whose currency will appreciate against the US dollar towards year-end, but the US will seek to deflect criticism towards China. Everyone everywhere wants to depreciate their currency so that they can export to everyone else in order to create jobs. It's not going to happen, but it is going to result in levels of trade protectionism rising in 2010-2011, inflation accelerating everywhere especially in Asia, and gold strengthening as its currency premium increases. Prepare yourself for increasing social strife and racism in cities and towns throughout Europe.

## Be prepared

Finally, monetary debasement is the theme I want to leave you with. As I said at the start, this may be the end of the recession, but it is just the early phase of the debt crisis. Do you really think that the debt levels accumulated by our governments will be paid back without incurring inflation and debasement? Don't wait for interest rates to rise, albeit more slowly than the rise in future inflation. It will not help to solve the debt problem. Rather, it will end the current ability to service the debt and keep a business alive. Debt, inflation, unemployment and falling living standards in Europe and the USA does not bode well for world peace. Prepare yourself now.

Above all, buy gold, then buy some more.