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Market Comment

CLARMOND

The Chains that Bind…

In every era the global economy is based on high quality collateral. In the 1800s it was the British Empire's credit which supported world growth, specifically the development of the United States. However, small changes in the terms of credit can have significant and unexpected knock-on effects on collateral.

PRESIDENT, GENERAL, MASTER OF slaves, exterminator of Indians, promoter of white rights, and guardian of the 'whipping machine', Andrew Jackson led a young United States, a nation and a people hungering for land. Jackson's 1830 'Indian Removal Act' provided carte blanche for the legal obliteration of the Five Civilised Tribes - the Creeks, Choctaws, Chickasaws, Cherokees, and Seminoles. Their 100 million acres of rich, black soil covered Alabama, Arkansas, Florida, and Mississippi; on these lands planters hankered to grow cotton, the 'White Gold' that was in desperate demand from the northern industrialists of the British Empire.

American green seed cotton yielded coarse fibre that was ideal for producing cheap cloth, thus making it competitive to Indian textiles. Therefore a chain of credit flourished that fed the expansion of cotton and the slavery it demanded. Foreign capital invested in high yield American bonds (8% vs. 3% British rates), the proceeds of which, via pricey New York financial intermediaries, were passed to local banks, then onto Jacksonian planters that placed their assets (their slaves), as collateral to produce the cotton that was finally sold to the mills of Liverpool and Lancashire.

In effect, global credit was investing in collaterised slave bonds that generated the critical cotton needed for Britain's continuing industrialisation. British investors, at the end of a long chain of collateral, actually owned American slaves. But as long as credit flowed, the 'Southern Lords of the Lash' and the 'Northern Lords of the Loom' remained in a profitable embrace.

Money, money everywhere…
Back in London, three events from 1833 to 1834 created tremendous liquidity within the credit system:

1) Branch banking, away from London, was permitted;
2) The East India Company's China trade monopoly was abolished, opening up the opium trade; and
3) The Emancipation Bond, at a cost of 5% of Britain's GDP, purchased and freed all Caribbean slaves, and paid British slave owners in full, bailing out their balance sheets.

What to do with all this new money? Chase high yields, of course. American bonds provided both the yield and a secure collateral. American land and slave prices exploded, cotton fever brought 'flush times'.

Reading the wrong signals
By 1836 the Bank of England, distressed over the loss of gold reserves, invoked the 'Palmer Rule' which suggested that raising interest rates would lead to increased gold inflows. Rates were increased from 3% to 5%. American rates skyrocketed, fracturing the chain of collateral; American land and slave prices halved, cotton fell 25% and defaults mushroomed. By 1837

Time for an improved $20?

America entered a sustained depression. The BOE had misread and misunderstood the complex interplay of collateral and balance sheets, causing unintended havoc.

Fed Be Aware…
A small rise in rates by the issuer of the world's high quality collateral (Britain) had crippled the global credit chain, particularly the collateral of the rising emerging market of the 19th century (America).

Today the Federal Reserve manages the world's high quality collateral from which all credit is manufactured. As the Fed embarks on a slow, steady series of rate rises, the leveraged balance sheets of low quality assets will come under strain.

The Bank of England soon reversed its Palmer rule error, and Britain did not suffer for long. America, whose balance sheets were shattered, only recovered thanks to the California gold rush, nature's version of QE. If the Fed needs to reverse its rate rises, America will be fine, but beware all other markets, in order to preserve your local balance sheets, you will require your own QE. ■