

Monday, April 23rd 2018

Dear Chris,

At Yokosuka naval base in Japan a US Navy 'Nimitz class' nuclear-powered aircraft carrier is moored. It has unlimited range, is 330m long, weighs 100,000 tonnes, and carries 80+ fighters; it projects a fearsome power. Its genesis lies nearly a 100 years ago at the Washington Naval Conference. The participants met in 1921 with the explicit goal of not repeating the pre-WWI battleship arms race of the Imperial German and Royal Navy fleets; they imposed key limitations on themselves relating to specific tonnage quotas per nation.

The US and British navies, each were allocated 525,000 tonnes, the Japanese 315,000. As a comparison, in 1914, the Royal Navy was 2.2m tonnes, the Imperial German Navy 1.2m tonnes, therefore this was a massive reduction in naval capacity. Additionally no battleship was to exceed 35,000 tonnes, and even the gun calibre was specified; cooperation was replaced with legal compliance and competition. Aircraft carriers, not being battleships, were largely ignored. However, with their massive potential power they quickly emerged as the key area of rivalry.

This clearly illustrates that politicians and generals always fight the last war without looking into the future. It is the same with central bankers. The defining lesson of 2008-09 for central banks was that uncontrolled and unsecured

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credit growth, with its interest rate priced in LIBOR, nearly brought down the system. Central banks stepped in with QE (in its various guises) and expanded their balance sheets to keep financial system afloat.

However, this policy is now no more. The future, central banks have decided, is secured lending, backed by 'safe' AAA government bonds. LIBOR will be replaced by a panoply of localised secured overnight lending rates, the US version being called SOFR (Secured Overnight Financing Rate). We are moving from a global unsecured to a local secured credit world, from a navy of battleships to a navy aircraft carriers, from cooperation to competition, as each central bank shall now launch its own secured lending rate.

All this secured lending needs more AAA government bonds that can only be created by greater budget deficits. How fortunate for governments that credit growth now demands deficits. The result? Clearly the 'safe' collateral is at risk of becoming unsafe, as more and more and more of it is issued. Central banks, like the Naval conference architects, are still fighting the last war.

See you in London on Tuesday - Mustafa