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December 2013
Market Comment

CLARMOND

The Red Queens

A character from a Lewis Carroll classic has disturbing parallels to the plight of our current Central Bankers. They seem to be on a never ending treadmill of credit creation in order to buoy asset prices and protect the 'wealth effect' formula.

AS THE SUCCESSION OF JANET Yellen is confirmed, perhaps a review of another famous sequel Through the Looking Glass by Lewis Caroll, may be warranted. In the follow-on story to Alice in Wonderland, Lewis Caroll introduces us to the Red Queen, who amazes Alice by how fast she can run, although seemingly without actually getting anywhere. After a particularly tiring session the Queen and Alice have the following exchange:

Alice: "Why, I do believe we've been under this tree the whole time! Everything's just as it was!"

Queen: "Of course it is. What would you have it?"

Alice: "Well, in our country, you'd generally get to somewhere else - if you run very fast for a long time, as we've been doing."

Queen: "A slow sort of country! ***Now, here, you see, it takes all the running you can do, to keep in the same place."***

Everything stays the same

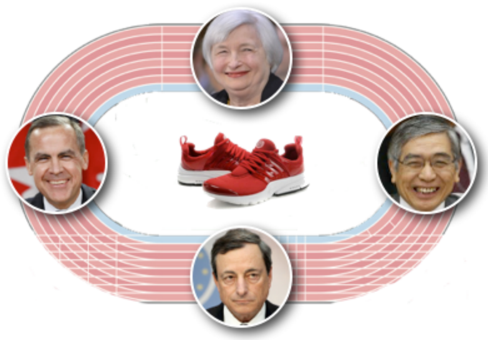
This image of perpetual movement to maintain one's constant position, an infinite running track, is a good metaphor for the global economy and asset prices. Both need uninterrupted credit growth to continue their steady upward movement. The only time, since we moved away from the gold standard, when total credit did not grow was in 2008; the repercussions of that slight slowdown are still with us.

The world's leading Red Queens, Haruhiko Kuroda at the BoJ, Mario Draghi at the ECB, Mark Carney at the BoE and the soon-to-been crowned Janet Yellen at the Fed have gambled on sustaining credit growth via the dual policies of Zero Interest Rates (ZIRP) and Quantitative Easing (QE). The rationale is that as credit expands so asset prices shall inflate in parallel. Our rising asset prices will create the fabled 'wealth effect', making us all richer and convincing us to spend more borrowed money; thus the circular chain of credit and asset price growth marches on.

As with Alice, the Red Queens are having to run faster and faster just to stay in the same place and in order to stop the credit system from draining and to keep asset prices stable. The emergency QE red running shoes are still very much on.

The missing part

For the Red Queens' wealth effect to succeed in the long term, it must be accompanied by increases in income. Red Queens generally dislike these as wage rises tend to be 'stickier' and much harder to undo. However, the majority of people are 'labour owners' rather than 'asset owners' - i.e. they are working for a wage rather than using assets as a bottomless piggy bank. Hence it is rising incomes, not rising asset prices, which are essential; this is the missing ingredient in the currently employed 'wealth effect' formula.



On your marks...get set...

Our looking glass

In the story, Alice finally feels that the Red Queen is 'the cause of all the mischief'. She shakes her continuously until she turns from the Red Queen into Alice's pet kitten. Alice then emerges from her hallucination and finds herself at home.

The view that our current Red Queens are also the cause of all of our mischief is unfair; the financial system, post gold standard, has been constructed on credit as the key driver of growth and asset prices. Many people may disagree with how the game is being run, but the rules are clearly set out; play, invest, profit, or lose accordingly; or step aside.

Like Caroll's Red Queen our Central Bankers must perpetually promote credit at ever increasing speeds to maintain asset prices and growth. As the latest Red Queen joins the race, we hope that Janet Yellen is tying her laces tightly. ■