Intervention can distort the markets

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Bond king Bill Gross is sceptical central banks have helped. Source: Supplied

Asked whether US interest rates should be altered by the central bank in September, December or even possibly 2016, the late economist Friedrich Hayek, without question, would have told us it really doesn't matter.

This is because at the heart of his and other like-minded "Austrian" economists' thinking was the belief that interest rates, like many other natural market forces, should solely be self-determined by the economy and market, not government agents such as central banks, legislators or bureaucrats.

Such beliefs are almost heretical in contemporary financial and economic life, and even proposing such concepts would have one burned at the metaphorical stake, even though those persecuting are often unaware as to why such beliefs offend them.

This debate is by no means new, but what is remarkable is that so few wish to discuss these challenging perspectives in an era when, clearly, nobody disputes governmental meddling within markets has caused bizarre results that cannot be explained by Nobel laureates, central bankers or even Wall Street investment bank chief executives.

No one school of thought or theory is ever the single answer, but ignoring all else at the expense of championing one single dogma is what led Soviet socialism to dismal failure and possibly may lead US democratic capitalism to an even worse fate.

This is because, even though the Soviet mantras had some international reach, no global market system has ever had the universality US-led capitalism has enjoyed up and until today.

Those who dispute that what we are witnessing is in any way atypical or unnatural need only consider this week's graph, which clearly demonstrates that bonds, equities, hedge funds and even currencies all suffered in August.

By doing so, they contradict the basic laws of the financial jungle which posit that, in the simplest of terms, if one goes up the other(s) should go down and vice versa.

The profound question for the global investor is why we need to remain wedded to this incumbent dogma and mindset, which clearly is no longer serving any of us at all well.

In ultra-high-net-worth advisory, there has always been a trend to allocate quite sizeable portfolio tranches towards so-called "alternatives", which include assets such as hedge funds, "liquid alts", private equity or venture capital.

A lesson that could, at this time, be learnt from these alternative managers is the art of determining one's own valuation parameters, growth metrics and benchmarking thresholds.

In other words, not all market participants seek out value or opportunity on the divine say-so of the US Federal Reserve chairwoman Janet Yellen or US Treasury secretary Jack Lew.

Larger-than-life bond manager Bill Gross recently framed this predicament as "feeding a fever, starving a cold".

The "fever" in this case is financial bull markets being fed with 0 per cent credit. The "cold" is fiscal austerity from balanced government budgets and soft corporate balance sheets.

However, for those institutional managers and global investors with an eye on China, the insights of Hayek and the Austrians may make a lot of sense and aid us in our investment decisions.

Proponents of Hayekian economics believe that a sustained period of artificially low interest rates, in any economy, causes excessive credit creation.

This results in a volatile and unstable imbalance between savings and investments.

As this mismatch then tends to stimulate borrowing from the banking system, the Chinese Communist Party reined in state-owned bank lending around 2010.

However, what happened in practice was that "shadow banking" — non-bank lending facilitators — filled that void.

For all intents and purposes, they lifted the Chinese credit expansion to Herculean heights.

The Austrian business cycle theory states that distortions in the availability of credit are the true contortions in any cycle.

This is why, today, the People's Bank of China and the Politburo, quite ironically, sit between the same rock and hard place that the US Federal Reserve finds itself.

Where this "malinvestment" starkly differs between blocs is that, in the US, unimpressive corporate and private sector investment is leading to a boon in consumer goods spending at the expense of much-needed capital goods — such as new roads, infrastructure and non-real estate construction.

Inversely, in China, the opposite is being seen, and the concern with this scenario is that this "malinvestment" is doing little to aid the Chinese progress from an industry-driven economy to a consumption-led economy.

Caught between these two tectonic plates is Australia, which, in the Hayekian framing, is put in an even less favourable position.

This is because, in its simplest form, Australia's interference in what should be a naturally self--determining interest rate, according to the Hayekians, closely mimics the Federal Reserve's benchmarking.

Those who lived through the era of former US Fed chairman Paul Volcker will remember Australian interest rates exceeding 20 per cent plus!

Yet Australia's immediate economic fate is indisputably linked to the fortunes of the Chinese.

What many alternative investment managers succeed at is determining for themselves where the natural costs of capital should be priced, and when to accept or to ignore published growth metrics.

The question is, if governments exited our free economy where would the natural rates of interest, the value of money and, for that matter, exchange rates sit? Even though many of us might consider ourselves laymen when it comes to these questions, it should not be forgotten that, while amateurs built the ark, professionals built the Titanic.

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