Rational Investing LLC

manish.aurora@rationalinvesting.com 212 466 1119 August 2009

The End of Anglo Saxon Capitalism, the Decline of the Dollar, and All That Nonsense

Recently there has been widespread criticism of US / British style capitalism and more specifically, attacks against the USD as a reserve currency, by the political leadership of France, China, Russia, Japan, the IMF et al. While I will not go into individual motives here, it will matter seriously to portfolios how currency values play out. If the dollar is indeed at risk of imminent collapse, then it makes sense to finance Emerging Markets purchases using it. If instead, it is going to be a bulwark, then a portfolio should be balanced, and for periods, even concentrated in dollar cash flows.

There are at least three reasons to be positive on the US Dollar vs. other currencies, and indeed freer rather than more constrained markets, and they are not entirely separable. The first is an immediate geopolitical reason. The second is more important as the historical driver of USD value. The last, perhaps vital, reason has to do with the evolution of democracies.

What drives the reserve status of a fiat currency? The immediate answer is free and liquid markets, and the issuing country's military capability and willingness to project such capability to protect those markets. The U.S. has 11 aircraft carrier groups, 60 odd Los Angeles class nuclear submarines and enough highly trained foot soldiers abroad to have effective presence from Japan to South Korea to Afghanistan to West Germany at any given time. This is what truly allows central banks, whether those of Saudi Arabia or China or Europe to use USD as a reserve currency. When King Abdullah wakes up and looks out the window, he sees the USS Nimitz parked from a recent run in the Pacific, and knows that the US 7th fleet protects oil shipments through the Persian Gulf. The Germans know the US nuclear umbrella stopped a couple of dozen Russian divisions from rolling in during the cold war. While the current account deficit, budget deficit, or GDP are good for short term trades, no one seriously worries, yet, about the Dollar as a store of multi-generational wealth.

The second, deeper reason starts with the Magna Carta, circa 1215 A.D. for those whose history classes are a hazy memory. Since signing that document, the Anglo Saxons have done two things right: 1) There has been a steady and consensual (as opposed to revolutionary) progress of individual rights, and by extension real and intellectual property rights, and 2) their markets have been kept open, no matter what the circumstances. The British Parliament signed a Bill of Rights in the 17th century, Henry VIII eliminated the power of the church to constrain the rights of a King, and by extension his subjects, the US Declaration of Independence shifted rights from the sovereign towards individuals in entirety, the U.S. Civil War ended race/ethnicity as an absolute constraint; eventually, colonization and apartheid fell as a barrier to market wages and access to capital. At the same time, most countries derived from British jurisdiction maintained liquid share and debt markets, while due process and just taxation were enshrined in US constitutional amendments. I do not know the parallels in Australian, British or Canadian law, but in the scheme of things the systems are not that different.

Whether by chance or intent, there is now an 800 year track record of preserving individual wealth, and this engenders a certain amount of confidence in contracting. The extreme example is the Duke of Westminister, whose 'family office' has provided a 999 year lease for the US consulate in London. It is no co-incidence that the Windsors are among the few European elites who kept their heads through the rise of nationalism. As an individual, I would take the Pound or Canadian or Australian Dollar just fine. But for liquidity, the center of gravity of democratic population* average human capital backing a reserve currency for global trade becomes the United States. As a result, the USD offers a unique record of jurisprudence AND liquidity required to serve as a reserve currency.

The alternatives being brandished about – a blur of Yuan, Ruble, Euro, Yen etc. have no record yet of defending individual property against expropriation. My shares in a Russian telecom firm were expropriated in 1997; I always thought the recent bull market in Russia one big cruel joke, and wondered what due diligence institutional investors did on their ability to enforce their ownership. China, too, has no record on property rights to speak of, and there may yet come a day where expropriation of foreign capital is a real outcome, not just a risk. From a point of view of valuation, this raises the discount rate on assets, or indeed all promises made in that currency. The Euro is potentially in trouble because of limited mobility of people and capital within its borders, and unsustainable government participation in the economy. In a hundred years, perhaps the Euro will be a meaningful competitor, if the UK and France merge their nuclear deterrent and the Europe coagulates politically. The ECB, a transnational central bank, may become the model for issuing other regional currencies. On current trends of human capital growth, the Indian Rupee might be a candidate in the next century, if India matures as a democracy, and by corollary, as a jurisdiction. For those who find this assessment of China too pessimistic, consider what it took to hold a free election in Iraq, and what might be needed to achieve the same debut in a country of a billion people. The short answer: a potential revolution, or two. While there is no shortage of disaffected groups - Tibetans, Uighurs, rural/Central China et al, the real revolution might come from property owners resisting government fiat, in a fashion similar to the UK in the thirteenth century. China's progress does not have to turn violent by any means, but until a democracy is formed, reserve currency status for the Yuan does not merit consideration. Japan is choosing to shrink, and its military is constrained by recent history, and eventually may prove too small to be capable of supporting a reserve currency as other contenders emerge.

So the last question is, what if the US just blows it? i.e. the next 2 or 3 liberal (by the US definition of the term) administrations spend $5 trillion each they do not have, and we end up just another banana republic? The answer goes thus: The rich want the lowest possible taxes while avoiding a revolution, and the poor want the most welfare spending while avoiding inflation. Revolutions hurt the purchasing power of equity owners and inflation hurts the purchasing power of wage earners. Democracies are good at negotiating these goals, and in reality the goals are quite compatible. In the US, the final arbiter of our democracy is the

Senate, and it requires 60 votes, i.e. the acceptance of a law by 30 states, for a meaningful check to be written. That remains the most powerful backstop against financial profligacy that I know of. The House of Representatives too, while primarily tasked with bringing home the bacon, has been known to find political balance when it counts. While bureaucrats such as the Federal Reserve's Open Markets Committee are less predictable, they are working for their reputations, and today Sir Alan might wish he had held rates 50 bps higher, not lower, during his tenure. So, to my mind, US spending and inflation will remain constrained relative to what some countries might accept in the circumstances, and the USD faces little contest in our lifetimes.

So what of that equity portfolio? Rational Investing's view would simply be to go where the risk adjusted valuations take you, and to take jurisdiction risk seriously. The back-of-the envelope method would be to inject the sovereign spread into the equity valuation. But for a slightly longer view, look at the multi-decade record of enforcement of property rights. And, if there is none to speak of, caveat emptor.