We have to consign the era of financial engineering to ...

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The last week has been interesting in the world of finance.

Greensill Capital collapsed. The provider of what might best be described as unusual forms of supply chain financing to what seem to have been vulnerable companies unable to offer what seem like conventional security for loans, the model ran out of steam despite the support of former Prime Minister David Cameron.

Significant numbers of companies are left vulnerable as a result, from the UK's third-largest steel manufacturer to banks that had provided Greensill with its funding. They bet that they could fund a reward from financial engineering failed, as is so often true, and the edifice has collapsed.

Some of the same banks that will lose on Greensill, and most especially Credit Suisse, seem to also be exposed as a result of the collapse of the private hedge fund, Archegos Capital. That this was predestined to failure seems to have almost been assumed by its name, but still the banks funded it.

And as, once again, has happened before, providing funding for stock gambling has proved to be very expensive for those involved. Eventually the egos on display in these environments overrule sense. The cost is always significant. It will be many billions in this case.

Neither of these failures is the least bit surprising. Each relied on a punt that continual funding of leveraged financial positions would by itself provide the security required to make repayment. In effect, the size of the punts would, it was presumed, create growth that would yield the return to justify the risk within the differing, and yet similar in the sense that they were financially engineered, positions taken.

There is nothing new about this. The whole 2008 crisis was based on false assumptions of similar sort that by forever extrapolating a position no breakpoint would be found. Before that there was the failure of Long Term Capital Management in the 1990s. And there are ample others. The fool, whether they be technically described as a banker or not, and their money seems always to be willing to part with their money when offered returns that can only be realised if a market can continually grow.

We could, at one level, shrug this off. Both failures will be costly. David Cameron looks dodgier than ever. Some banks have been bruised. C'est la vie, it could be said. But that would be unwise.

I noted an article on inflation risk in the FT by someone called Andrew Parlin. To describe him as an inflation fetishist would be fair, but at least he had the honesty to lay bare his fear. He said:

[A]n entrenched inflation such as we have not known in decades and the need to slam on the brakes through aggressive rate tightening [is the risk that exists]. Given how inflated asset prices are, the bust that would follow would probably be unusually severe and protracted.

What he is suggesting is that there aren't just isolated examples of excessive risk-taking on the basis of asymmetric betting right now, but that the entire financial market is currently built in it. Asset values are, as he is honest enough to admit, utterly distorted. The distortion has been created by low interest rate policy, linked to low inflation.

There is an inverse relationship between both low interest rates and inflation and financial asset prices. If financial assets pay broadly steady returns but interest rates fall asset prices rise to approximately equate the two. If inflation is also low then there is an extra boost for asset prices as lower risk discounts need not be applied. Both situations have existed for so long now asset prices are seriously over-inflated.

Parlin's naked fear is that this situation might reverse if there was to be inflation, and that to prevent that asset price crash then the real economy must be sacrificed, in his view. Unemployment, austerity, and small-town corporate failures must all become the norm to maintain orderly asset pricing, even when it is recognised that those prices are seriously over-inflated.

Leaving aside questions of desirability (because it is patently undesirable to do this) and necessity (which is doubtful, as the inflation paranoia on display is not based on real-world risk, but on textbook ones instead, and the textbooks are wrong) what Parlin is saying is that financial markets are one entire asymmetric risky bet, all premised on the idea that interest rates will stay low in perpetuity. That may be true. But, when everything else in the economy has to be sacrificed to making good on that bet it is clear that the risk has moved from being routine to asymmetric. In other words, it can only continue to be justified by the perpetuation of the bet itself. That is the logic of the Ponzi, or pyramid selling scheme, of course. And that is where the whole of financial markets are.

Parlin wants effort to be directed to maintain this edifice. I rather suspect some self-interest in that desire. That self-interest might taint the views of many. But it should not stop us from realising that once a bet reaches this stage it is always, eventually, going to fail. It is only time before financial markets must adjust to the very obviously absurd valuations implicit in them.

That is not because interest rates need change, because I doubt there will. There is, in my opinion, almost no inflation incentive for that to happen. It is instead because the risk evaluation within markets is wrong. Most assets are being valued as if they offer near-guaranteed returns. But that is not true.

In finance, returns will fail because the bets are all wrong.

In energy, returns will fail because we have to reduce oil dependency.

In raw materials, returns will adjust to declining consumption.

In retailing, returns will fall as the shop beings increasingly irrelevant.

The same will be true in commercial property.

And the transport sector has not yet priced the adaptation to alternative energy, sufficiently.

Whilst tech has not priced changing tax rules.

Markets are going to decline because they gave mispriced risk. Oddly, inflation is not one of those risks. But that will not prevent a fall. The fall has simply been deferred by low inflation and low interest rates which have disguised the real risk of fundamental economic change.

Greensill and Archegos have failed because of mispricing risk, believing financial engineering can offset the real underlying economic factors that they chose to ignore. The signal that they provide is that the whole market is doing the same thing. But that does not mean we crash the real economy to maintain the financial edifice. We do instead invest in the real economy to create new worth.

We have to consign the era of financial engineering to history. But will we? It’s an absolutely fundamental question.