THE CANDYMAN

. . . Oh, who can take tomorrow, dip it in a dream . . . the Candyman can
. . . talk about your childhood wishes, you can even eat the dishes . . .

Entitlement takes root at a very slow rate, easing up on us the same way we became so deeply in debt. The Candyman works us as he works a school yard, with tastes and gifts and samples until we wake one morning hooked and dependent. The school-yard Candyman, unlike Congress, at least works in cash.

So entitlement is born, not by fiat and not in the world of cost/benefit, but in a manner encouraged, a manner born of dependency, a manner cloaked in worthy goals, a manner so subtle that no one is to blame. The first Henry Ford, for example, saw a decent wage as a precursor to selling cars; no charity, he, but a hard-nosed car builder who had just enough human empathy to recognize that happy, well-fed workers would buy his cars. In return he asked for a work pace far beyond what the farm boys hired ever experienced at home.

At first, those farm boys were only dependent on Henry for wages. And I suspect it began there, with their being pushed, hard. Like all excesses, the correction, too, was excessive as witnessed that day on the Overpass, but the die was cast. Power or leverage or whatever you may call it, got something extra out of your job. Dependency bred entitlement no matter how you sugar coat it. I am hard put to find an entitlement cult prior to old Henry at least for we common men. The power brokers and, as Henry called them, the money men, the bankers, yes, there certainly was an embedded sense of entitlement, for was it not always so for the Aristocrat, the fortunate few? Of course their presence spawned the common man's assembly into his own Aristocracy, the union.

Back and forth, then, through the decades, the battle waged for what slowly came to be known as "rights," a right to work, a right to a decent wage, a right to safe working conditions. Some enlightened few even saw that for every right there was a duty, but by and large the worthy point of many rights, and they are many, gave way in many places to a universal "all." Rights came to be defined well beyond equitable and ethical grounds until we have, today, the right to a salary increase every year, the right to health insurance and, why, may I ask, not life, car and boat insurance, too?

Dependency and its child, entitlement, were helped along by another "d" – debt. Growth in companies created growth in profits. Growth means somebody bought and bought often. But when you study wage growth since World War II, you are struck with the differences in consumer spending, profits and wages. Of course, the answer is debt, be it credit cards or home equity loans, but consumption grew faster than incomes, and cash incomes grew slower than corporate profitability.

It seems to me that, in the act of fulfilling our nearly every want, we came to view the fourth television or the third car as *needs* and so reinforced our own link between debt and entitlements. We'll set advertising, greed, jealousy and ego aside for now and simply posit that entitlement is but the other side of the dependency coin, lubricated by debt.

A journey to understand what has happened, I think, is needed to have a blurred picture of the next few years. To my way of thinking, debt, dependency and the dollar are forces that for now will drive investing. There are many other issues, of course, but in this Quarterly the prevailing

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trends are those three. The largest single factor these three forces will impact is inflation. One of the preliminary conclusions I draw about the next two years or more is that inflation, not deflation, is ordained. Deflation is still possible, but the events leading to it are both too grim to list and still a low probability.

Sales abound all year long. "Stuff" is always on sale. The Internet levers the buyer. The rise of China and India gave us ever cheaper labor. Goods are abundant. Services are abundant. Global availability of shipping, communications, money, labor, exotic machinery, etc. is in full flower *somewhere* all the time. Through all the explosive years of new products (cars, airplanes, sewing machines, radios, telephones, and on and on) from steam engines up to World War II, well, even Alan Greenspan notes that prices rose *and* fell ". . . for a net change of near zero." He goes on to note *that all changed when we came off the gold standard in 1933* and ". . . the Consumer Price Index doubled in the two decades (or so) . . . following . . ." For example, from the fall of 1954 until late summer of 1955, the Consumer Price Index fell every single month versus the prior year, while stocks and commodities rose. Mass production set the stage for ever-lower prices on goods . . . but someone dropped the curtain.

In theory, an explosion of debt which helped finance rapid growth should have pushed prices down as efficiencies of production, cost reduction via large-scale manufacturing and cheap labor created ever lower unit costs. Think of it: Faster shipping, instant communications, automated assembly, automated tooling, prior to 1933, these types of changes regularly created deflation. As far back as David Wells (1889), it was noted that in the 1887-1889 period the sum total of all the world's steam engines equaled the labor of one billion workers which was 3 times the working population of the planet. And that's just steam engines. Deflation and disruption, from business cycles, obsolescence of old products, new products, were the order of the day. Schumpeter's "creative destruction" aptly names those times and these. And therein lies the rub, that disruption, that problem that kept pushing one party or another in or out of office, that deflation that hurt the holders of debt.

Off the gold standard then, and on to Harry Truman calling for a worthy post-war goal of full employment, made inflation the law of the land. How, you ask? Because Fed policy from day one of its existence is to *calm* disruptions. Milton Friedman, for example, argued that money growth slightly more than productivity growth would do it. Paul Samuelson argued it was the role of the government to step in when disruptions occurred. Pick your poison, but in either case, absent a fixed currency, printing money became a policy tool. I feel a need to repeat: Printing money is a policy tool. (When gold was the bench currency of the land, paper money converted always and forever to gold at a fixed exchange rate. Absent that, there is no real limit to printing money.) We became the world's currency, use it to buy stuff and then China or Germany or whoever also prints money as we do, and they use it to buy our Treasury bonds, our printed money. By the way, the last bond retired by our Treasury was in 1960.

So having chosen to prevent another depression and control disruptions of over or under production, product obsolescence, labor issues and the like with inflation, it was a natural and easy step to also protect lenders. Some cynics might argue the latter was the whole reason. Our government debt grew from the simple ability to do so, absent a fixed currency standard. (Gold, whales teeth, whatever "standard" you wish, including obscure sea shells which are still in use on remote Pacific islands as a currency, limited by scarcity, there is no inflation until dollars arrive.) Our personal debt also grew, both from a sense of entitlement and the lure of cheap products which made them even more attractive. The cheapest product we can get is debt for after all it's all about the monthly payment. As job security is another "law of the land" these payments were no barrier. (I contend the monthly payment, not the total price, drives most purchase decisions.)

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Perhaps this crude linking of debt and dependency doesn't convince you. Perhaps printing ever more money to produce ever cheaper goods appeals. We have a current example we can study that gives us a fair sense of the result of excess government debt, and a goal of low unemployment: Japan.

- In the last 10 years, industrial production in Japan has declined by 1/3, exports have declined by 50% and their total Gross Domestic Production fell between 6% and 10%. Unemployment, however, is 5.5%, quite low. How, you ask? By job subsidies to corporations with government debt; put another way, by government spending and "support" of otherwise bankrupt banks and corporations or, as my deeply cynical hedge-fund friend says, the government owns and runs everything.
- Japan's total debt is twice their GDP (we are 80%).
- For almost two decades now the *cost* of their debt, not the debt itself, is greater than the output of the entire economy. Debt is thus created to pay interest, the ultimate Ponzi.
- Deflation was created, true, and it has driven debt costs down, but that same deflation destroys corporate profitability, which lowers GDP, etc., etc. How, you may ask, can they do this? Key to it all is they are a nation of old savers, an older average citizen, by and large, saves, i.e. buys the government debt and, voila, Japan becomes a creditor nation. That is ending, we suggest, but two decades of debt, deflation and no growth is left. Why they save is cultural, age driven and beyond this paper, but it's changing. We, on the other hand, to avoid the Japanese experience, are *inflating* to lower unemployment, inflating to make $13 trillion palatable and inflating to finance ever more government solutions, bailouts, etc. and, best of all, we are aging and becoming savers. See any parallels? Japan is, to my mind, Washington's secret fear.

We all know the magnitude of the debt, which is the issue of the day. Only real growth can pay it off. At one point (and I would attribute if I could find the source) someone proposed only 5 bad choices were left to us today, given that we likely cannot grow fast enough to pay our debt down to a tolerable level:

1) Print money and risk hyperinflation coupled with more frequent recessions;
2) go back to gold, let banks fail and cut all spending and taxes;
3) start over – privatize everything, no taxpayer obligations, lower taxes; (the "guard the coast and deliver the mail" model);
4) just do it – spend, create big deficits, higher taxes, rely on productivity to save us or,
5) ease into any of the above.

Debt, per se, is not bad. It is the ability to pay it back that rules, as Japan has discovered. The key, for us, is the buyer of our debt. Anything in surplus, such as our debt, is worth less or, put another way, takes more incentive (the interest rate) to buy it. Moves in interest rates on our government debt pulls other rates along over time, even that of better credits.

So why are interest rates now so low? Two reasons: 1) demand for safety, not yield, has dominated for 18 months pushing price up and yield down (but as the risk appetite returns with better times, safety-driven demand for U. S. Government debt will diminish and it has to become competitively priced) and 2) an active Fed policy to keep short-term rates low "for an extended period of time."

To my mind, then, the Fed

1) is willing to accept a bubble in stocks stemming from far too much money in circulation;
2) favors the person or company in debt by providing ever-cheaper dollars to pay their debt and assuring their continuation as employers;

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3) keeps inflation an unwritten law of the land along with jobs;
4) is afraid of falling into the Japan experience;
5) favors keeping banker spreads attractive to protect the banking system and
6) accepts devaluation of the dollar as supportive of our exports and limiting our import buying.

Is it any wonder national unions are still seeking more? It's worked so far.

Is it any wonder, then, that universal health care polls at near 1/2 the population when, in fact, near 1/2 the working population accepts some form of government check, be it welfare, military service, state, Federal or local employee, post office, border patrol, and on and on? And, by the way, nearly 40% of those employees are unionized.

Is it any wonder our Democrat President is viewed as a "Corporate Democrat" given all the Wall Street types he hired? And Bernake, well, that's a separate paper. Point is, the future is being bought with debt; forget what party is in office.

Is it any wonder, finally, that many see this continuation of a government in our lives (be it either party) as no more than a means to stay in power much less giving a damn for me, or thee? Mrs. Pelosi has made it clear that she, for one, is prepared to give up Democrat seats in the House, sacrifice her own party members, to pass universal health care and to assure her own job as a friend of the working class.

Which leaves the dollar, the red-headed stepchild always beat on. It is the thermometer of all our fiscal and monetary behaviors. The world swaps it for gold, oil, stronger currencies or Sovereign debts, depending on the prior mentioned need for safety or on what Congress does or does not do about the $13 trillion.

Accordingly, the dollar is no longer the only, much less the pre-eminent, reserve currency. As the Euro and gold holdings build in Asia and the Near East in synchrony with Congressional decisions, hard assets priced in dollars move also. Of course, it remains the desired unit of trade at local levels in most all economies, but you can bet the farm that their governments are hedging. All in all, its trend is down. Now, in fairness, it is the Virgin Queen compared to the Euro and their Tower of Babel in ideas, languages and economic biases on how to work together in the European Union. The carry trade and currency traders will continue to distort its value day to day, week to week, but the dollar reflects the level of confidence worldwide in our ability to pay our bills. The trend isn't encouraging.

One can argue, then, that inflation is here to stay and, most important, that keeping it under control argues for frequent tightening by the Fed with the usual following disruption of the business cycle. How ironic – it was supposed to smooth cycles, this policy of printing.

Real estate, in a micro sense, oddly benefits. By micro, I mean apartments, service sector facilities and eventually industrial. (A long steady decline in the dollar makes our goods cheaper to the world, implying some hope for manufacturers.) Real estate sees fixed debt costs and a rent/lease price model positively influenced by overall rising prices. Apartments, ultimately, do well as foreclosures continue.

Inflation drives corporate profits up, but there are reservations about how quickly that will add, net, new jobs, so unemployment stays high, overtime rises and temp help firms continue to do

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well. Note that the number of folks now drawing emergency (not regular) benefits has risen from 2.8 million to 4.7 million in the last 6 months.

My friend Joe Horonzy postulates in one of his many models of the world that by and large people fall into 4 categories: dumb/rich, smart/rich, dumb/poor and smart/poor. Given an oncoming two or three years of high unemployment, sub-potential GDP growth (ex the bounce back), rising inflation and rising interest rates, one is tasked to define how each of these 4 groups behave. Certainly the stocks focused on the smart/rich will do very well, especially given the growing number of Asian and South American new wealthy. More important to me, however, is the "middle," the middle-class white- or blue-collar worker who, to my mind, has paused his spending/debt binge. I have no sense yet of there being a diminished sense of entitlement on his part or from *either* Aristocracy for that matter. The dumb/poor are already being hurt, just note the massive increase in tobacco taxes (the poor have a higher ratio of smokers than the rich) and cap and trade will increase all heating costs which is a major portion of their income

So, if entitlement persists in all its forms and is supported by whichever party is in power, we would do well to assume continued dependency on Washington and we should expect to see continued nationalization of various industries and organizations. The most recent? Home care workers in Michigan.

So, the smart/poor see more entitlements offered for their vote, the smart/rich see the same and we go elsewhere to invest with some of our stock money. Certain domestic stocks remain attractive, but that list is a lot shorter than a decade ago, and we must consider a higher risk of periodic recessions and a more cyclical business cycle.

One cannot escape the reality that, in spite of our self-inflicted difficulties, the world as a whole is still growing economically. Power and water and basic goods are still in critical need in most of Asia and Africa. The Middle East is looking more and more like it's ready to start tearing down centuries-old institutions. World growth, I believe, has yet to hit its full stride. Many will be left aside or disenfranchised of what little gains they may have while despots struggle to retain a control they know they will ultimately lose. Overall, growth continues and, critically, because it is new to many emerging nations, their path will mimic ours of the 50s and 60s – filled with fits and starts and moments of panic as they slowly learn how to balance monetary and fiscal policy, growth, dependency and their emerging middle class. To the extent we have experienced and understand these cycles we may invest with them a bit more securely.

I am bullish. How can you not be when you are sober, the punch bowl is empty and opportunities abound in spite of the world's leaders' best efforts to impose their version of Utopia?

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