# CALVIN AND HOBBES

It is not a question of whether contemporary economic thinking will change, but how quickly.

The father of all economics, Alfred Lord Marshall, said that when mankind became aware that it could influence its "mean state" then " . . . the desire to put mankind in the saddle is the mainspring of most economic study."

For centuries, man's lot in the world was believed to be determined either by God or nature. Born to serfs, you were a serf, as were your children and their children. Born to wealth or power, such was yours generationally and few questioned it for that was the nature of life. Resignation was the word.

Only in recent decades have a brave few rejected this hypothesis and become aware that they could influence their economic station – their lot in life. Avoiding starvation gave way to improving one's conditions.

Powerful questions arose and the greatest was whether these individual choices would add up to what was good for all or whether this new awareness would destroy. The solution lay in the question: as society began to change, man used this new adaptive awareness to change with it – he was literally compelled to do so.

The human evolution that birthed unparalleled improvements in agriculture, science, education and the like sprang from the early awareness of those brave few who simply rejected their assigned station. In time, man began to study these changes and through hundreds of experiments and thousands of observations a science of analysis – economics – emerged. In the last century and a half, these analytical results synthesized into schools of economic thought – Socialism, Capitalism, the Austrian School and dozens of variations of each.

In a simple way, these schools fell broadly in two camps

- man is substantially unable to think and act in his own best interests and
- man is capable, both singularly and collectively, of deciding his fate.

This ugly debate persists, now also reflected in politics and religion.

The damage from these two basic viewpoints arose from the very people who had been content to simply analyze man's adaptation but now began to credit their analytical work with predictive and, thus, manageable aspects. There is a difference:

- mankind has progressed rapidly over the last 150 or so years as has been recorded, but
- managing or controlling that evolution has proven to be far more difficult – to say nothing of forecasting it.

That has not stopped the old economists who believe, whatever the school, that the progression can be managed. The old economists do not see man as adaptive, but simply as ignorant. Herein lies, as always, the solution to today's issues: man has always adapted and always for the betterment, in spite of endless errors along the way. I, for one, stand in awe of the arrogance of economists who continue to believe their actions, their school of thought, significantly influences

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economic events. The wish for economics to be a predictable, repeatable science with known outcomes, well, dies hard. In school it was post hoc ergo propter hoc – after this therefore because of this . . . which works only in the physics lab.

Distracted, finally, from the post-war ennui of the credit binge and the now slow death of entitlement programs, Americans today are being forced back into the adaptive mode. The collapse of the "truths" that home prices always rise, credit cards are a path to luxury and jobs are plentiful if your entitlement funds run out has triggered a very sobering reassessment of a now not only wiser, but much older population. It has also brought into sharp relief the often-ignored third player on the stage – the opportunist who exploits the battle between adaptable man and ignorant man. The end to this period of laziness, for lack of a better word, has, as I see it, significant impact on some key elements in our society. In the few paragraphs that follow, I'd like to take the chance, based on this adaptive thesis and man's ability to work in concert, and predict some likely outcomes. New economics in one sense; a return to our root economics in another.

**No Bank Left Behind**

In a simpler, earlier time, leaders made all decisions. Food, barter and, ultimately, money was the lubrication of their power. As ever, an asset spawned an institution – banks. In simpler times, banks accepted deposits and lent them out. With post-war credit growth came all of the non-banking businesses that banks engage in and, for a time, served to distract them a bit from their traditional role. Today, however, banks have added, formally, the critical role of being policy implementers for whichever school of thought dominates Congress and the White House. "Too big to fail" now reflects, to my mind, not the domino effect of interwoven banks, but more the loss of a policy tool of Congress. [It is Congress – all else, the Fed, the Agencies, etc. are their doing – only.] One need look no further than the immense profits paid to these banks to hold, at near zero cost, depreciating dollars to lend at – well, pick a rate; 13% on credit cards? 4% on a mortgage? All in all, near pure profit at any rate. Their cost for this role? Hold, distribute, swap, buy the offerings of the U. S. dollar printing office.

This is not a domestic quirk. The same, to an extreme, holds true in China, the U. K., Brazil – most anywhere. Banks may be owned by shareholders, but openly now, run to implement policy. I fail to see how, in the long run, shareholders will do as well as senior – most – management. To me, regional and smaller banks, being too small to be policy tools, represent value. The bigger the firm the less it interests me.

**No Country for Old Men**

Having more or less debunked the power of Keynesian (or Monetarist) economics to overcome mankind's innate ability to simultaneously adapt to circumstances <u>and</u> defeat the most elaborate of economic controls (taxes, regulatory bodies, credit availability, fiscal stimulus, etc.), I see little value in kneeling at either altar. Sail trimming? Yes, they can do that. But as we see, for example, in the socialized governments of Europe where ostensibly massive government policies are in place and working, equally massive underground (read "adaptive") economies flourish. What better example than the value of a pair of Levi's in the old, pre-wall Soviet Union?

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I believe we may safely conclude that should a continuation of the current Administration occur or even if a new, more laissez faire Administration emerges, Americans have crossed a line and no longer believe some – any – economic policy will cure their ills. It is truly the time for the broad re-emergence of the entrepreneur – both in business and in plain old thinking. A time of entitlement, now decaying, is forcing a wiser citizenship to look inward for solutions. Slow? Yes, but the best and brightest who have been doing this all along will serve as examples for the less gifted. Age is on their side also. For we investors, I believe it means: find banks that back these folks, find small, user group-specific needs that group might have, find, by simply looking at self-sufficiency, what is needed to be that way. Expect a generation of older, retired workers to re-enter the work force not as Walmart greeters, but as entrepreneurs, advisors, consultants, technical problem solvers – and note what they need to do it. The proscriptions and prescriptions of old men who view economics as manageable because mankind is ignorant are over – we have seen the results when <u>really</u> tested.

**Calvin and Hobbes**

Americans and citizens of other first-world developed nations see adaptation in different ways. In socialized nations such as France, health, employment, food and the like are a given and adaptation is found at a less important level. In our deep-south or damaged inner cities, however, little is taken for granted beyond the need to continually adapt.

Endless books have been written around the "why" of so many Americans' distress. Some point to lack of opportunity or to lack of familial influence or even society preferring a group be held down. David Ricardo wrote long ago of the iron law of wages, for example, postulating that excess labor would always push wages down to a bare subsistence level and keep it there. (He also noted that increased productivity of that labor, i.e. some workers more skilled than others, led to higher wages for contributions to higher productivity.) In many places the Calvinistic view of predestination – you are what you are meant to be – remains deeply embedded in the minds of many adults who can't seem to escape the poverty of their lives while so many around them succeed.

It seems to me the distracted, entitled, credit-fueled binge of the last 60 or 70 years was seen by many as their particular version of Calvinism – their lot was a predestined good one and clearly due them. No free will, which Calvin preached, seemed palatable if you had acquired the requisite material goods – you could speak of having free will – but knew it had limits that were acceptable to you.

Today's American consumer is in transition from his self-deception of entitlement and about to discover that Hobbes was right – self-interest and free will – enlightened self-interest if you wish – can coexist with others of like mind because of man's adaptability. Today's consumer, and tomorrow's, will be far different:

- Self-employed, they may do their job anywhere and in many cases via the Internet, and remain in a closer family circle.
- They will consume fewer goods, but of higher quality for some and budget for others.
- They will seek smaller homes for the reduced cost and increased freedom.
- They will dine out more, not less, and offset that with more home-prepared meals.
- They will have closer ties to family and community.

- They will see more movies and read more books in lieu of saturated and increasingly vapid television.
- They will be outdoors more.
- "Make do" will be not only acceptable, but will be a required badge of belonging.

The list goes on – and it's an easy list to create. One need only think back (or read) of life in harder times and study what Americans did before $5 per day wages, before the post-war boom. To my mind, the key trend will be a decline in the need of multiples – multiple cars, homes, TVs, and the like, and a subsequent rise in the demand for higher quality across the board, as a surrogate for reduced, "buy two" buying power.

So, Hobbes won. We are not predestined, we can adapt, we do have free will; it's rusty, but still sound. That comic strip was no metaphor of life – it was a lead indicator. As wages remain under deflationary pressure and jobs remain scarce and we Americans face an ever-older population expecting income and health programs to assist them, I firmly believe the now widely scattered concept of family will re-assemble in mutual aid. My lead indicator of a return to simpler times is weak, but *Milan Fashion Week* shows the 50s all over again, "Heritage" (looking like an earlier time in men's wear) for men – and ongoing demand for the cars of the 30s, 40s and 50s.

**The Definition of Evil**

The hallmarks of the next decade are three:
1) rapidly rising government debt needed to
2) finance an aged population that is
3) delevering – spending less, paying down debt and producing fewer toys.

Woven through are enormous pressures on wages as jobs remain scarce, mobility limited and technology persisting in reducing human workers. The middle class will suffer the most if unskilled, the unskilled poor less so and the wealthy will see a shrinking of their optimism and their reserves – both financial and emotional.

It is obvious that in prior business cycles, Savings and Loans or steel companies, perhaps a chain retailer or two, went bankrupt – and we moved on. This cycle, we see governments going bankrupt while some firms continue to flourish in spite of reduced demand. Governments will have little choice but to expand debt to meet an old population's expectations, to wit: Japan.

I, for one, suspect Bernanke believes so strongly in himself that, to him, a little inflation is possible and, subsequently, a cure. (Increasing dollars paying fixed-amount debt – hurrah for Ben!) The trillion plus that banks now hold, <u>if not lent</u>, poses no inflation threat. <u>Keeping</u> them unused, however, will force the Federal Reserve to pay the banks some market rate of interest that, to the banks, offers a profitable spread and none of the risk of actually lending money. That rate – for doing nothing – will push all rates up, <u>without</u> inflation.

As we watch Greece, Portugal, Italy and Spain, one is struck with the incredible interest rates they must offer to move their debt – and they have still (so far) very low inflation – about 3% for the entire Euro zone. Those rates, of course, make it extremely hard to borrow money for, say, a new plant, some automation or even so prosaic an item as a home – so we know what's coming.

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Americans (and most Europeans) know, deep down, that spending on entitlement programs is at the root of all issues and the governments involved are grossly indifferent to the future cost. We may talk more about it here (I note the Italian " . . . no problem . . .") by contrast – but so far it's talk in Congress, yet as they talk they know what they have been doing for decades is wrong. They have, to a country, assumed fellow countries (China?) would step up and bail them out if and when – as we have Argentina, Russia, et al. They knew, I believe, they were all doing it, all making the same assumption, but like our Bernanke, felt they would be "first out." If this sounds like a third-world stock market or Ponzi scheme played with Sovereign debt – well, you get it.

These are not stupid people. Third rate, yes, but not stupid, defined as unable to learn. Neither are they ignorant people, defined as unaware of facts. When elected officials are not acting in the best interests of the nation, yet they are neither stupid nor ignorant, I conclude they are evil.

**The French Connection**

I think it worthwhile to illustrate the depth of what I think of as the useless sectors that we fund with tax dollars. Noted in my Weekly was my point: we can cut waste and useless expenditures without seriously impeding growth and literally force the "released" to either retrain or become entrepreneurial or work at a reduced salary while simultaneously paying folks we need more – much more.

When I think of useless civil servants layers deep, for some reason I think of France, to whom this part is dedicated. All of what follows, I gratefully attribute to the insightful work of the Chairman of the Board, Patrick Byrne (PhD Economics), of Overstock.com, now known as "O.co."

Q1) How much do state and local governments spend annually in total?
A1) $2 trillion [*2010 Statistical Abstract* – U. S. Census Bureau]

Q2) How big is their combined deficit?
A2) $60 billion [*State Budget Update 2009* – National Conference of State Legislatures]

Q3) How big is their "crisis" budget?
A3) 3%

Q4) How much does the U. S. spend on K-12 education?
A4) $700 billion [U. S. Department of Education: most recent 2007]

Q5) How many students go to K-12 government schools?
A5) 50 million [National Center for Education statistics]

Q6) How much does the U. S. spend per K-12 student?
A6) . . . about $14,000 per student

Q7) What is the U. S. spending vs. the Organisation for Economic Co-operation and Development (OECD)?
A7) 41% higher

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All of this leads to 4 simple math problems:

Q8) How many children are in an average classroom?
A8) 24.6 [National Education Association database]

This works out to about $344,000 per classroom. That, in turn, begs the obvious question of what a teacher and classroom cost:

Teacher: $59,954 ($47,208 wage + 27% or $12,746 benefits) [data is Bureau of Labor Statistics and National Education Association]

"Rent:" Heat, light, cleaning, common space, CAM, etc. of 25' x 40' (1,000 square feet) times $20 rent = $20,000 total direct cost per classroom annually.

So we do the math:

$14,000 times 24.6 children equals $344,000 per classroom, but teacher and building costs equal $80,000 [$59,954 + $20,000]

Who gets the other $264,000 being spent?

If you guessed administrative staff, well done. In most of the world, teachers are valued. Given a better performance review process and power to fire and, I would argue, the wrong people are getting the $264,000. We could attract the best and brightest to teaching – just pay more – much more.

Milton Friedman notes that we would save a fortune by letting children drop out of government schools, get a $6,000 voucher (each) and save $8,000 per child. Assume only 20% take the offer. Savings? $80 billion. Combined state deficits? $60 billion. Now you see what Greece currently faces and we are terrified of.

Conclusions, of sorts:

The New Economics is the adaptation of an older, experienced nation to the evil of their elected leaders. They do this by reducing dependency on the government, turning to each other, avoiding taxes to force the public work force into their camp and create, in an almost feudal sense, a work culture and a financial culture based on tangible goods (barter, for one) instead of entirely on paper money. Economic growth continues, government data about it is less reliable, the corporate balance sheet is seen as trustworthy via the Darwinism of corporate life and we muddle away a decade. New leaders arise, the grandkids have a chance, the old complacent, no, entitled mentality lingers, but dies. Economics as a profession is distraught trying to analyze and predict human behavior – which is my point.

If you read this far, thank you.

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