PULLING IT ALL TOGETHER

When I began writing these Quarterly pieces in late 2005, my intentions were simple. I planned to write about interest rates or the rate of economic growth or taxes and other such quantifiable elements of an investor's world.

Through 2006 and 2007, this approach made sense. In early 2008, however, my numerical investor perspective began to change to a broader, more behavioral view. Why are investors seemingly ignoring basic financial data? How do we explain buying the Sovereign debt of bankrupt countries? What's causing this kind of decision making? The first indicator I gave for this change in my thinking was this, from the Quarterly ***Dear Senator*** of April 2008:

> *"Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preference of the competitors as a whole, so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences (sic) to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise (sic) the fourth, fifth and higher degrees."*
>
> John Maynard Keynes

This insight into the world of Common Knowledge is 77 years old. It caused me to write and think differently as the financial world behaved ever more strangely and toyed with global collapse.

Most of us working in investments turned first to ever more detailed analysis of traditional data, hoping to find any explanation for the oddities we were seeing. Among many, I was struck by a very activist Federal Reserve beavering about printing money and talking about a recovery based on this "wealth effect" they predicted. Some 18 months or so later, in 2010, talk of a New Economy was gaining attention beyond just financial types. (***Navigating the Reef***, October 2010). A perfect storm of flawed policies, flawed leaders and debased currency became obvious to the popular media, but I still needed a better understanding of what was happening – I saw no wealth-induced recovery, only asset inflation. However deep I went into the data, I felt there was a piece I was missing. I needed 1) an understanding of the immediate impact of the solutions being pursued and 2) an insight to how all of us, investors included, would be affected by those solutions, <u>especially</u> in the long run. The year 2011 was about to arrive and false recoveries and ultimately false solutions were the order of the day. Nothing was working as promised.

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My transition to a better understanding of this New Economy was, of course, a series of half-starts and dead ends. What persisted, though, was the gut feel this was all running on more than the usual flawed economic thinking I had come to expect.

In January of 2011 (***Headwinds***), I arrived at the firm conclusion that 2% growth was the foreseeable future and for a great deal longer than was popularly believed. In spite of numerous pundits (and especially Wall Street) calling for 3% and even 4% growth starting in late 2011, I based my lower view on the collapse of credit-levered consumer buying and, in fact, them also reducing debt. The snowball effect of the collapsed auto and housing sectors, both heavy users of downstream semi-skilled and unskilled labor, contributed heavily to the collapse of consumer confidence and spending. Unemployment was high for many but low for the educated and I felt it was to stay that way for years. This was not a garden-variety recession but a consumer and government credit collapse, too. To me, the weaker business cycle had taken on some very long time attributes in spite of repeated Washington assurances and Fed theories that the recession was ending.

By April of 2011(***Civilization, Act II***), and the failure of the economy to recover to prior levels, an idea I had was growing that unorganized individual action towards a single objective could be the powerful impetus for a real recovery. The idea of humans acting like schools of fish became a theme for my thoughts about national recovery. A singular mass action needed a trigger, though. My “mass action” stayed focused only on a recovery, however.

In July 2011 (***Snap***), I began to explore what it was that would cause this “schooling” behavior and a few months later (***Unintended Consequences***, April 2012), decided it was **unconscious survival decisions, on a scale never before seen.** It was driven by our lizard brains. Here I wandered off to see if subconscious decisions from our primitive brain had unintended consequences and came away satisfied they did . . . and still do.

This potential of primitive survival instincts on a global scale, however, helped me understand a great deal more of the schooling behavior I was beginning to see in Southern Europe, for example, but, as we’ll touch on in a moment, also alerted the insightful (not me, sadly) of the likelihood of abuse of this basic human instinct. Behavioral economics – the study of why consumers do what they do – turned out to be a two-way street for the unscrupulous. The world was in a Keynesian love fest, the Fed Stimulus was “the answer,” no one spoke out loud of mind games and a wealth effect remained elusive. I still focused on recovery triggers.

Between these pieces on human survival instincts I continued with views on when a full recovery might be in place (***2017***, January 2012), the dangers and need for Fed intervention to deal with shadow banking (***QEternity***, October 2012) and finally (***The Bazaar,*** January 2013), noted that widespread anxiety was the fuel, if you would, for that schooling impulse, that absolute need to survive and that markets, at least, do survive because of it. That was my turning point from the economy at large to the markets in particular.

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In July of this year (***Or So It Seems To Me***), it was theorized that some external trigger was still needed to launch leaderless but very wide, focused, collective action and I assumed the fuel would be anxiety. Clearly, I wrote, the Fed was done with the Stimulus Fuel. It was true as far as it went, in stimulus terms, until I began to consider all the times I had dismissed them as just "academic economists."

It has long been my core belief that academic economists have little value in the real world of economics and finance and often could be ignored. I mistakenly thought they generally stayed in the university world of theoretical economics. Wrong again: The "social scientists" among them were quietly influencing the Federal Reserve Bank in all new ways.

My view has been that Fed staff and most of the academic economists extant, lacking accountability and lacking experience with working in a reward-penalty world, leads them to publish personal theories of growth, consumption, the impact of taxes and the like. It is frequently nonsense, suited only for the tenure track and obscure Journals of like thought. They have, over time, demonstrated no particular ability to find solutions as all the issues on which they theorize still exist. Bad enough, surely, but when imposed on others as public policy it is regularly wrong, or late, and very damaging. When their solutions rest on mathematical models they also become laughable. When they began to use psychology to push unfounded personal theories, however, they became deadly.

This is the world of today's Fed and these are the people who seek to manage not just their original duty ("...provide liquidity to the banking system …"), but also inflation, unemployment and, of late, growth itself.

My analysis of their work made it easy to call contemporary economists and their concepts of induced demand, a fraud. My having prior found both Keynes and Friedman wanting, and with current practitioners of the dismal science showing minimal regard for Hayek and others of the Austrian school, this judgment of fraud is, to me, obvious. If you'd like a partial refresher, try ***Calvin and Hobbes*** (October 2011) or read *Seven Fat Years*. More on that in a moment.

And so we turn to the present where we find those same economic thinkers offering excuses as to why all their elaborate theories (QE, et al) haven't done anything to restart the economy. For the first year of this Great Recession (or less, frankly), Fed action likely saved the day – let's give the Fed that. Now, though, we have Paul Krugman on the left claiming economic growth is no longer attainable unless an even greater amount of money is printed and Tyler Cowen on the right agreeing that growth is over because nothing seems to work. At least Cowen doesn't call for more printing – I think.

The low level growth to date is what I think of as normal, organic growth from the "haves." Recall that about 2/3 of all consumption is done by the top 1/5 of the population by income – the bottom 1/5 account for about 3% or 4%. It has little or nothing to do with any "wealth effect" or renewed confidence and a great deal to do with the passage of time and the wind-down of middle class debt. Self-correcting comes to mind because no one told the middle class consumer – that middle 3/5 – to reposition themselves by paying down debt – quite the opposite. It all simply needed time.

Noting the Krugman/Cowen left-right agreement, John Tamny made a few solid observations: Bad economic times, he said, focuses voters and you get a Reagan to fix the disasters of the Nixon and Carter years. Good economic times, he goes on to say, lead to lackadaisical voting and thus second-rate thinkers like Bush (W) and Obama. Both thought cheap money would stimulate growth, both revived the tax-and-spend policy decisions of the 70s, both failed, both were fed by traditional conservative and liberal economists.

The solution is not complex. You cannot stimulate consumption (growth) until you first stimulate supply and supply <u>needs</u> confidence in the future. Absent supply, you can literally hand dollars to consumers and they will likely first pay bills, second, save some and third, chase goods and services – and they likely will skip step two – why not, the government is giving out money. All PC until you realize goods and services are in short supply, more money chasing few(er) goods is inflationary and you have debased the currency even further by printing those "stimulative" dollars. Why this escapes most people amazes me. Many argue "a little bit" of this approach is fine. Trouble comes when that little bit doesn't work and grows into a QEternity, as now – see Krugman, above. Trillions of excess dollars are sloshing around the globe waiting for a spark – any spark. This is not theory; examples abound in many nations over centuries of time: Impede production and your economy struggles, give political leaders excessive amounts of money and they will rarely if ever use it wisely.

What does work to restore confidence is removing the tangible barriers to increased supply along with full enforcement of the one thing we hypocritically lord over the rest of the world: Force of law.

The barriers, however, all the ones we've written so many times about: Corrupt special interests, bought and paid for politicians and, above all, excess regulation and taxation – now called fees. All this from excess money printing and, well, that's another paper about ethics.

You can blame Nixon. Tamny makes the point held by Art Laffer, Jude Wanninski, Jack Kemp, Robert Mundell, et al, that when Nixon took the United States off the gold standard we lost our only anchor – a stabilizer – to our dollar money supply. The shock of ensuing dollar devaluation gave us the oil crisis of the 70's. There was <u>no</u> shortage of oil; good grief, global demand is less than 5% a year. OPEC merely did the obvious and priced it correctly to quickly devaluing dollars. The total departure from gold as an anchor was a fatal move and

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OPEC knew it. Incidentally, I suspect oil is probably worth between $15 and $25 a barrel, OTBE.

Let me be perfectly clear here: gold's use was as an anchor for the dollar, not a currency in place of the dollar. The British mistake of freezing the ratio of gold to the pound froze their economy and caused them to give up and unhook the pound from gold. Belatedly they learned that, yes, the ratio had to be adjusted periodically to reflect growth or the need for it, but the political will to do that sparingly gave way to doing it to print more pounds – or dollars. Need I mention why politicians need more dollars than the underlying economy can support?

Once we unhooked, that simple decision created booming commodity markets. Faithful readers will recall near every commodity in the world is priced in dollars and the oil nations, for one, saw the unhook as a precursor to devaluation and inflation. They did what you or I would do when offered a falling dollar for our product – raise the dollar price of our product. For future reference, note that when commodity prices boom, economies tend to struggle – and vice versa. It wasn't then, or now, an energy problem, but a monetary one and controlling just the money supply doesn't work – Friedman notwithstanding.

> [If you would like a great read on this whole period of change, by a non-economist, I recommend Robert Bartley's *Seven Fat Years* wherein he reviews the 80's. I will be tapping into his thinking in future writings.]

Which brings us full circle back to Keynes, his Common Knowledge view and our individual lizard brains. To me, anyway, it grows clear that initially just survival, driven by very high anxiety, had the controlling role in investors' minds. Their losses were huge, they were desperate, many lives were ruined and they were open for any answer.

In *Weekly #221*, I mentioned that my expected wide, common movement has already begun, but in a very unexpected and dominant place that we call " the market." How we got there is of interest. The story as written by Ben Hunt begins with the German Stuka dive bomber of WWII. This war machine carried an extremely loud air-driven siren that terrified people on the ground as it attacked. The plane was more a psychological weapon than a bomber. The fear component was literally wider than the bomb damage. This "Jericho Trumpet," as Ben Hunt describes it, was the loud, authoritative "voice" of the moment . . . and it was, in fact, a slow, lumbering aircraft soon dispatched by the RAF.

Hunt has illustrated, in his own excellent analysis, my own evolving thread of concentrated anxiety and subsequent common actions leading to a mass behavior, not unlike terrified civilians who cowered when the Stukas came. He noted similar fear-based mass behavior is now alive in the current global bond and stock markets. This place was not the obvious one for the arrival of a truly global "mass movement" because worldwide, endless experts all pay enormous attention to analysis of debt markets, economic growth rates, earnings trends and dozens of other economic metrics. One can barely fathom ALL of them schooling. Oh, we all accept that there are brief times when things go sideways without any apparent cause.

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We each believe, however, that we add some alpha, some value, to the overall analysis and decision process. The reality is we are now more a mass schooling than ever in my memory and certainly for this length of time. Some of us figured out the Fed Trumpet was more noise than fact. We paid for that insight as "dumber" investors did well.

Never have we heard an Authoritative Voice, our Federal Reserve, once trusted to be neutral, be so loud, so persistent and so dominating, worldwide. It's impact on creating growth is non-existent, but it surely has tried.

Instead, says the Fed Trumpet, you don't know what you truly need, we know what's best, we have the data and we will manage this. "We have here (holding up a piece of paper reminiscent of Senator McCarthy in the communist witch-hunt days) an International Monetary Fund Document or some Bureau of Labor Statistics data or some PhD thesis done by our staff that proves, mind you, this will work etc., etc." The siren grows ever louder, the free markets and creative destruction grow ever dimmer.

Ben Hunt goes on to quote a line from *Cat on a Hot Tin Roof*:

> " . . . there ain't nothing more powerful than the odor of mendacity . . .
> you can smell it. It smells like death."

"We have our minds and institutions under assault by a particular brand of intellectual orthodoxy that cements its soft, authoritarian control by a psychological persuasion of our social, animal brains." Hunt said it well.

Now what, you ask. What do we do when we are wired, as I noted a few years back, to respond to our fellow humans at a subliminal level, to the SNAP of unknown origin? How do we deal with so powerful a survival instinct that has a focus contrary to our desire for growth? Is it that powerful, really, and are we swept up in a false school and all is lost? Will normal growth return or will the Fed persist in believing only they can cause it?

I think this market is our personal "Snap" moment where we decide to withdraw and hide, or think for ourselves, or join the crowd. Regular readers of the Weekly should guess where this is going. For now, two messages: 1) we are working to understand not just what to do about these times, these markets, but also why and how they have come to be, and 2) this is how easily liars can lead. Voltaire noted that God is on the side of the big battalions – for us, that's all the current market players combined. For now that has to do as we await an honest voice.

This time, and certainly for the last two or more years, investors have behaved as one – an unique situation given its duration. Some tried to remain rational, arguing that the data simply did not justify this constant bullishness. The bears, as I noted in *Weekly #222*, simply folded and joined in. Not, let it be again noted, because they were agreeing to a rising market, but to why it was rising. The Trumpet Fed had arrived and the world's markets now widely embrace this "Common Knowledge." It has nothing to do with growth or recovery.

I think we have defined reasonably well what's going on. It seems, too, that a recovering economy, something NOT done by the Fed, is coming along naturally to, in part, justify some of this stock market insanity. That will be explored more in the January 3rd Weekly for my clients.

Too hard to accept that the Feds' psychological management of the economy is now in place and for a very long time to come? Well, the Fed is now not only playing the Common Knowledge game that Keynes wrote of, but is covertly leading it. The Fed, like it or not, is using the media to tell investors what to believe and backing it up with actions to make it so. The latest is columnist Hilsenrath telling investors what to think about tapering as is "indicated by the market." In fact, circular logic aside, "the market" knows only what the Fed says is "the market." Which still has not resulted in a Fed-induced recovery.

The financial media has become the echo of the Jericho Trumpet. Instead of terror, Hunt says, the Fed goal is to turn what used to be a short-term tactical weapon into a long-term bureaucracy by using psychology, through the media, to create needed investor behavior – investors who would accept and buy zero interest rates and settle for that. Strong public statements about what "Everyone" knows creates a reality where it becomes rational to act as if we see this reality – even if individually we don't. We will soon be told the Fed has "created" a recovery.

The current stock market is, accordingly, perfectly rational. Read that again as it is The Common Knowledge.

Again, significant credit to Ben Hunt for his synthesis of thoughts and quotes, phrases and great insights that I would have hopefully arrived at, eventually, but not nearly as eloquently.

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