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The 'Growth Trap'

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Over the last 30 years I've read innumerable books, articles and papers by economists. And while I've learned a lot from these, I've also come to accept the conclusion of other skeptics: that economics is not a 'science', and that mainstream economists are wildly overconfident in the efficacy of their theories.

When I observe the current tenuous state of the World's Economy, I believe economists should shoulder the largest amount of blame. It is they, after all, who run our Federal Reserve and other Central Banks. It is they who counsel the Executive and Legislative branches on economic issues. And, unfortunately, after the bus runs into the ditch, it is they who are charged with getting it back on the road.

One precept I believe is at the heart of their errors: that all things economic should and will 'grow'. Here are some timely examples.

Budgets and Taxes. In the past 80 years the U.S. government ran a deficit 72 times ! When asked why this wasn't going to be a calamity the answer was always 'when the economy grows fast enough we'll increase taxes, which will create surpluses, which we will use to pay off the debt'.

This 'sounds' good, but look what's happened. Instead of surpluses we've run deficits 90% of the time, including record deficits in the last few years. And rather than even consider that their growth mantra might be ill-conceived, mainstream economists assert that we now need to create even larger deficits, and that these will finally create the growth that can be used to pay down the debt, and happy days will be here again. It was Albert Einstein who famously quipped that insanity was 'doing the same thing over and over and expecting different results'.

Pension Accounting. Actuaries assume their portfolios will grow at x % and, therefore, they'll have enough money to pay future benefits. The result ? A large majority don't earn what they projected and are severely under-funded.

Politicians' Projections. When our leaders assert that this or that economic plan will save $ millions over 10 or 20 years, those are 'always' based on an assumed rate of GDP growth that 'almost always' is higher than the resulting reality. I could go on and on.

It's a two-edged sword. Done with productivity increases and sound economic policies, growth raises the standard of living for millions. Used injudiciously, however, it is a trap that borrows from the future resulting in disruptions for many and, eventually, lowers standards of living. Most things in nature have a natural limit to their growth. One exception, cancer, if left unabated will grow until it consumes its host.

It is time we aggressively question our long-held, college-taught economic dogmas. It is just too easy to validate some feel-good theory by projecting growth. We should break the monopoly that these mostly Ivy League group-thinking economists have on Central Banks, politicians, and our future.

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Does Ben Still Have Our Back?

When Fed Chairman Ben Bernanke first used the word "taper" on May 22nd, we saw just how dependent markets are on QE (money printing) and the Fed's ongoing purchase of $85 billion per month of Treasury & mortgage-backed securities. The mere suggestion that QE might be slowed a bit produced an immediate -5% correction in U.S. stock prices, with much worse declines in foreign markets. Makes one wonder what would happen if QE were actually stopped, let alone (gasp!) reversed. And that doesn't even begin to address the eventual raising of short term interest rates, which appear stuck near zero indefinitely. We are now faced with the end of the "Ben's got my back" approach to both stock and bond investing, as the bellwether 10 yr. T-bond jumped in yield from 1.3% to 2.7% in very short order. Bond prices fall as int. rates rise, and mortgage rates also rise along with 10 yr. rates. Many, incl. yours truly, have long predicted the end of the 30+ year bull market in bonds that began in 1982 under the Paul Volcker Fed. It now appears that the lows are in and we can expect higher rates in coming years.

Having said this, few expected that the unconventional (experimental?) monetary policies of QE and ZIRP (zero int. rate policy) pursued by our Fed and other central banks would be taken to the extremes we've seen. Artificially suppressed int. rates both here and abroad have distorted price signals in virtually all asset classes and incented – some would say forced – investors to seek out higher returns outside of traditionally "safe" money markets, bank deposits & govt. bonds. This includes corporate debt, emerging market sovereign debt, utilities, REITs and other types of dividend paying equities. All risk being re-priced downward as bellwether rates rise and some level of "normal" rates is resumed.

But – and it's a BIG but – market reaction to the initial taper talk was severe enough that the Fed went into damage control immediately. A number of FOMC members & FRB Presidents, in interviews and speeches, emphasized that any reduction in QE would be data dependent and gradual. In other words, you liquidity junkies will be weaned off of your regular monetary fixes slowly enough that it won't hurt too much! Given how slow and fragile our economic recovery has been from the Great Recession, and the universal belief among policy makers that inflation is the lesser evil to depression, I would bet on continuing QE & ZIRP going forward, possibly for years to come. Even if our Fed slows down a bit, Japan, Europe & the UK are likely to continue or increase similar programs. Whatever mix of dollars, euros, pounds, Swiss francs and yen flood the world via continued central bank QE operations, it's hard to see any eventual outcome that doesn't involve painfully high inflation.

At VFA, we welcome a return to some sense of normalcy that will allow us to do what we do best – search for securities and sectors that are fundamentally underpriced, thus providing our clients adequate returns as well as a margin of safety. But we're compelled to consider the macroeconomic consequences of radical monetary policies, both here and abroad. Holding cash, short term bonds, and commodity oriented inflation hedges continues to make sense to us.

Those Who Don't Learn …
Doomed to Repeat.

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The Dow Jones & S&P 500 are at record highs. Gold is Down. Real estate is booming. People are buying cars, rental homes, taking vacations, and getting a Tee Time at 4:00 pm is difficult. Ah yes, people are spending again. In theory, the government's plan to induce a growing economy has worked. Shoppers have more money to spend, savers are being punished by getting no return on their cash and watching as some of their friends buy new toys and 'hot stocks'. Sooner or later many 'penny pinchers' may loosen their grip a bit for a bit more fun.

Had I just woken up from a coma, I might think it was 2007. (Except in 2007 you could get 4% CD's for a year.) We have an explosion in the tech industry, with aggressive product development designed to keep you attached to your electronics 24-7. Stock market indices are mountains higher than just a few years ago. The TV/radio ads for gold have all but disappeared. The real estate market is white-hot right now as houses stay listed for days instead of months. (I am pleased to be reminded that Peyton Manning is quarterback for the Broncos instead of Jay Cutler.) Ah yes, a growing economy helping people live the American Dream. But for how long?

I often ponder a fact my colleague Bill Mason has touched on many times: Our *$ Trillion a year stimulus program.* This comes from the Federal Reserve printing 85 Billion dollars ($85,000,000,000) a month! It's interesting how over the years our perceptions have changed about the value of money. This $85 billion is the same amount the US Treasury gave to AIG to keep them from going under. Then, people were furious at that dollar figure. "No More Bailouts" they chanted. Now we print that same amount of money every month? Here's a thought: America has a spending problem, and the Fed wants it to continue. Printing money and forcing interest rates to rock bottom levels is a recipe for enticing a shopping spree.

Fast forward to June 19, 2013. People are anxiously waiting for Bernanke to speak about the continuation of this stimulus. When Ben hinted the Fed might taper these programs down, markets around the world market tumbled. I think this makes clear that many investors don't truly believe in this recovery, and are likely to pull out as soon as they smell smoke. We've gotten so used to this easy money and spending, how do we stop? Won't interest rates have to increase 'someday' ?

Unprecedented money printing can't continue forever, can it? And isn't it likely, as has happened throughout history, that inflation will rise to compensate for all this money being printed? It seems to me, at age 32, that unless America's path changes dramatically, we are in the process of repeating an episode of history we'd do better to avoid.

Monetary Cocaine

William Mason CFA

The second quarter was one the worst quarters ever for gold and for bonds. David Rosenberg wrote the following on July 2: "According to the Streetwise column in Barron's, Treasuries are set for their worst year since 1978. Long-duration Treasury bonds are down 6.5% in the past three months and 9% for the year." Why are bonds going down? Because interest rates are going up. Remember my February 2013 report entitled What is Wrong With This Picture? I put a chart of interest rates going back to when George Washington was president. The rates were at a record low. They are starting to move up.

FPA New Income

FPA New Income was one of the few ports in the storm. It is one of the few bond funds that increased in value in the first half of the year.

Money Printing

In the U.S. and Japan money printing is viewed as the cure-all. That viewpoint will change. Jim Rogers had this to say in an interview at the end of June: "I'm very worried because this is the first time according to history when you have had all major central banks printing money at the same time; Europe, Japan, America and the U.K. All are frantically trying to debase their currency. We've had individual countries do it, you know Brazil. But we've never had all the big guys doing it at the same time. So, I'm afraid that in the end we're all going to suffer perhaps worse than we ever have with inflation and currency turmoil and high interest rates."

Stocks

Richard Fisher, the head of the Dallas Federal Reserve Bank, stated the following in early June: "We cannot live in fear that gee whiz, the market is going to be unhappy that we are not giving them more monetary cocaine." What he was referring to is the trap the Federal Reserve finds itself in. If they don't print enough money (monetary cocaine) the stock market will go down.

In addition, interest rates are increasing. Warren Buffett said that interest rates are one of "the two fundamentals that matter most to investors." Regarding interest rates he said: "These act on financial valuations the way gravity acts on matter: The higher the rate, the greater the downward pull."

I have known Bob Rodriguez since 1985. While he ran FPA Capital for 25 years it had the best record of any stock fund. Bob is now president of FPA. He told me in May that he has the lowest personal stock exposure he has had in his career.

Japan

Japan has taken money printing to a new level of insanity. Japan and Europe are big concerns of mine and they will matter. Bob Rodriguez told me in May that "Japan is a game changer." In simpler terms he said: "Japan is screwed." Highly successful hedge fund manager Kyle Bass said on June 11: "The beginning of the end has begun in Japan and I believe it began just a few short weeks ago. We've been following this a long time and I have never said that until now and I think it's in the next 18 months to 2 years that this manifests itself." He expects Japan to eventually default on their government debt which is at almost 250% of GDP now.

Gold

There is now a massive, all time record short sale position on gold. Those having shorted gold must eventually buy it. As Fred Hickey wrote on July 2: "I don't know how the US-based shorts will find enough gold to cover their positions." In addition, gold is still insurance against currency debasement.

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