UNDUE CREDIT

- Monetary policy has been a monumental failure in our opinion. Even with mounds of evidence that his measures (if not his motives) cannot be trusted, the Pavlovian response by the equity markets to everything Bernanke has done has been nothing short of absolute delusion that borders on blindness to reality. We believe that Mr. Bernanke attempted to retain the leadership role in this incestuous relationship with the equity markets by not announcing more policy initiatives last week. The reality is that the equity markets and the media expect—demand actually—the Federal Reserve-funded put option over and over again. The problem for the Fed now is that the premium for this put option has become exorbitantly expensive and more and more destabilizing to the very objectives it claims to be trying to reach: low inflation and acceptable job growth.
- For over a year now, we have written in these pages of the fundamental macroeconomic problems we face here in the U.S. They are not complicated—and not terribly dissimilar to those affronting Europe. Put simply, we face an imbalanced balance sheet that needs to be equalized through deleveraging. Artificial short-term approaches like recent monetary policy will just exacerbate and prolong the problems. With income growth stagnating and major investment returns negative or otherwise highly volatile, consumption must ratchet down to a new equilibrium, one very different than that to which our society has become accustomed.
- We can only hope that truly innovative (tax reform, employment training incentives, electrical grid restructuring, etc.) and responsible (elimination of superfluous spending and entitlement overhaul) fiscal policy is introduced and subsequently debated. Without that we fully expect another recession. The history of credit- and balance sheet-based recessions strongly suggests that's a very likely outcome. This will be particularly painful given where we are economically this time around.
- We continue to believe that equities are very difficult to defend from a risk and return perspective. We have an environment where over 50% of the world's economies are in dire situations and risk has been rising parabolically at the same time. Risk premiums will have to rise as a result. The only way these premiums can be captured by the investor is for valuations to fall meaningfully from current levels. When this happens we'll happily exploit the opportunity tactically.

UNDUE CREDIT

The past few weeks of capital market action have been pretty extraordinary to witness. None more than last week's technical bounce in domestic equity markets. While such volatility and roller coaster-like dynamics have become the norm of late, there's nothing more laughable than the media's attempt to explain it. The more things change...

It was suggested that the large upswing was due to the expectation that Fed Chairman Bernanke was going to announce the onset of another round of Quantitative Easing (QE) during his address at what historically has been an academic conference in Jackson Hole, Wyoming. Leading into the speech it was clear that the Fed was leaking to the press that such an announcement was not forthcoming and the market began to sell off. The immediate reaction to the speech was disappointment and the market plunged. Not to be discouraged by the failure of the original rationale—Fed to the Rescue!— the ever-ready salesfolk of risky assets got busy and pushed a new story: Mr. Bernanke's comments regarding the economy were bullish. Cue equity market rally.

Entertainment value aside, what read on the current economic environment do equity markets expect from Mr. Bernanke? The truth? Wouldn't that be foolish. If we can give Mr. Bernanke credit for anything, it's his mastery of manipulating market psychology. Otherwise, his monetary policy has been a monumental failure in our opinion (unless the destruction of the value of the U.S. dollar and an effort to break the Chinese peg were the truer objectives). Even with mounds of evidence that his measures (if not his motives) cannot be trusted, the Pavlovian response by the equity markets to everything Bernanke has done has been nothing short of absolute delusion that borders on blindness to reality. Never mind that the classic transmission mechanism of credit and liquidity is broken, the emphasis thereof is completely off-point. We have a solvency and balance sheet problem not a credit and liquidity problem. Central banks around the world don't seem to grasp this reality.

As we pen this piece, in tandem with some tiny glimmers of light from various econ metrics (stretching the definitions of glimmer and light so very far here...) the equity markets are building up the next Federal Open Market Committee (FOMC) in September as the moment for an announcement of a new round of misguided monetary policy. Were that such hope and faith defensible in this (any) investing environment. We believe that Mr. Bernanke attempted to retain the leadership role in this incestuous relationship with the equity markets by not announcing more policy initiatives last week. The reality is that the equity markets and the media expect—demand actually—the Federal Reserve-funded put option over and over again. The problem for the Fed now is that the premium for this put option has become exorbitantly expensive and more and more destabilizing to the very objectives it claims to be trying to reach: low inflation and acceptable job growth. It's time for the Federal Reserve to remember its mandate and acknowledge the underlying fundamental problems facing our economy. We find it embarrassing to watch this ridiculous dynamic play out while so many Americans are truly suffering.

ELUSIVE SIMPLE TRUTHS...

For over a year now, we have written in these pages of the fundamental macroeconomic problems we face here in the U.S. They are not complicated—and not terribly dissimilar to those affronting Europe. Put simply, we face an imbalanced balance sheet that needs to be equalized through deleveraging. Artificial short-term approaches like recent monetary policy will just exacerbate and prolong the problems. As have the asinine Keynesian misallocation schemes promulgated by ideologues with no economic or empirical support underlying the fiscal insanity. Real wealth accumulation and the deleveraging process are long-term phenomena that cannot be realized by psychology or ideology. Responsible policies that address the issues of systemic underemployment, massive private and public debt levels and ever-depreciating real estate values are desperately needed. Sadly, the current environment leaves such policies seeming unlikely.

...TRUTHS SELF-EVIDENT

Economic theory suggests that wealth and income effects operate hand-in-hand with consumption behavior. Debt-based consumption habits are developed under the belief that income and wealth will one day be sufficient to pay off liabilities incurred. Income is generated primarily through wages and wealth primarily through acquired assets and investments. By far the largest acquired asset traditionally has been real estate. Clearly, given the current state of employment and real estate, theory would suggest that the imbalance must be addressed through meaningful changes in consumer behavior. That is, with income growth stagnating and major investment returns negative or otherwise highly volatile, consumption must ratchet down to a new equilibrium, one very different than that to which our society has become accustomed. Until policymakers accept this as a possibility we can expect more misguided and theoretically unjustifiable policies. Recent events certainly lend some empirical credibility to this supposition.

Again, the structural challenge facing most developed economies is the search for a new balance-sheet-balanced equilibrium. It's an issue of solvency, not credit availability or liquidity. The global central banking community in our view is disavowing this truth because they lack policies that can properly address it. They seem content with the violation of treaties (EU) and the massive expansion of their own balance sheets in efforts to cure a new illness with the same old medicine. It's a bit ironic that some central bankers are destroying their own financial balance sheets to address the dire imbalances of their peers, all the while misappropriating resources and failing to repair the balance sheets of consumers. So we're heading toward a scenario where private, public and central bank balance sheets all are in disequilibrium. What happens then?

DON'T KNOW, BEN?

Not to be too cynical, but what if an alternative interpretation to Bernanke's lack of policy details were due to the fact that the Fed has absolutely no idea what to do next? They recognize that the "things would be worse" defense of current policies has run thin on anyone with a modicum of understanding of even basic economics and so it may seem easier to say nothing and defer to fiscal policymakers (our elected officials). Even within the Fed they are disagreeing on policy—a first under the Bernanke Fed. With all of the current data pointing toward a meaningful slowing of the economy, the Fed Governors can't possibly believe that things are getting better. Not a chance. Rhetoric aside, it might just be that they've got nothing left to give.

Now the stage is set for the big fiscal stimulus plan that's apparently coming after Labor Day (and another vacation for the Obama's). You think that perhaps this entire episode was choreographed? Obama didn't want to be upstaged by Bernanke? Do we really expect this Administration to separate ideology from economics and offer initiatives that will really address the fundamental economic problems? We certainly hope to be surprised, but if history is any guide we're not terribly optimistic. If it's more Keynesian largesse it won't see the light of day in the House—at least we hope not. We can only hope that truly innovative (tax reform, employment training incentives, electrical grid restructuring, etc.) and responsible (elimination of superfluous spending and entitlement overhaul) fiscal policy is introduced and subsequently debated. Without that we fully expect another recession. The history of credit- and balance sheet-based recessions strongly suggests that's a very likely outcome. This will be particularly painful given where we are economically this time around. The economy hasn't even come close to recapturing the levels it reached in 2007. We believe this to be a scenario worthy of considering—meaningfully more so with each passing day of inaction—when managing wealth accumulation for clients.

ANALYSTS REMAIN UNDETERRED

To add insult to injury, simultaneous to all of the aforementioned we have equity "analysts" who are now ignoring most economist forecasts and continue to extrapolate historically high profit margins in perpetuity to conclude that equities are inexpensive. We have long written about the circular and conceptually inconceivable logic used to defend any and all equity valuations. We continue to believe that equities are very difficult to defend from a risk and return perspective. We have an environment where over 50% of the world's economies are in dire situations and risk has been rising parabolically at the same time. Risk premiums will have to rise as a result. The only way these premiums can be captured by the investor is for valuations to fall meaningfully from current levels. When this happens we'll happily exploit the opportunity tactically.

STILL HOPING FOR CHANGE

By this time next month we'll know what the new 'stimulus' plan will entail. If it's another Keynesian spending spree we hope that Congress has the fortitude to stop it in its tracks. If that happens expect the FOMC to announce QE3 and the equity markets to rally as result. Missing in all of this is the fundamental reality of financial economics. With more failed and ill-conceived policies our economy will enter a recession in the not-too-distant future. That, unfortunately, is a very likely scenario. All objective evidence leads us to that conclusion. Either way, change is coming—either we're wrong on the policy front and are pleasantly surprised or elections will bring sudden change. We sincerely hope that the change that comes is far better than that promised a few years ago.

IMPORTANT INFORMATION

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