Redstone Advisors

Economic and Market Review

First Quarter 2011

***"Two roads diverged in a wood, and I—
I took the one less traveled by,
And that has made all the difference."***

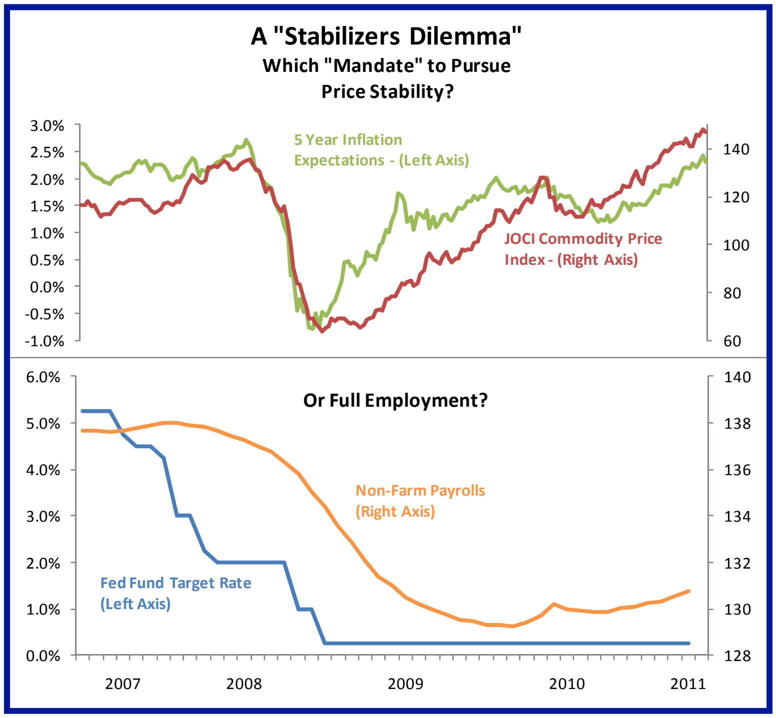
Robert Frost, *Mountain Interval*

To "QE", or not to "QE". With apologies to Shakespeare, that, it would appear, is the *only* question. Will the Federal Reserve extend its unprecedented program of money printing, euphemistically referred to as "QE2", beyond the stated expiration date of June 30, or will they instead cease and desist from their insatiable proclivity for monetary expansion? In truth it would be difficult to overstate the potential ramifications of this decision. Yet despite its overarching importance, there is not a clear-cut consensus, least of all from the entity charged with the responsibility for its disposition. In fact, over the past several weeks it has become apparent that the voting members of the Federal Open Market Committee (FOMC), are **deeply divided** over this question and have become embroiled in a vitriolic public debate. Those in the easy money camp point to the continuing excess slack in the US labor market and while characterizing the recent nascent signs of rising price inflation as merely **"transitory"**, these ***"doves"*** recommend caution and insist the stabilizers will be in no hurry to remove the record monetary accommodation. Those on the FOMC who are openly agitating for a discontinuance of quantitative easing cite instead the alarming rise in commodity prices and inflation expectations as **warning signs** that the stabilizers may now be at risk of overstaying their welcome. And while taking full credit for having saved the system, these ***"hawks"*** nevertheless, recommend a transition to a less accommodative monetary policy. The dilemma facing the stabilizers underscores our long-standing criticism of the Fed's farcical **"dual mandate"** which demands they conduct monetary policy in order to secure both **stable prices** and **full employment**. As we have detailed in the past, taken individually, both *"mandates"*, which are in fact the direct outcome of the operation of unfettered free-markets, are **unattainable** over the long-run by way of interventionist policies. However when taken together, these *"unattainable mandates"* are **inherently contradictory** and confront their pursuers with an **"irresistible force paradox"** – what happens when an irresistible force meets an immovable object? This dilemma is highlighted by **Figure 1** which illustrates the *irresistible force* of rising inflation expectations colliding with an *immovable object*, an employment market that remains stubbornly unresponsive to monetary stimulus. Speaking at the 1858 Republican Illinois State Convention against the political gridlock which had paralyzed action on a critical decision over the policy of slavery agitation in the South, Senate candidate Abraham Lincoln famously declared that ***"a house divided against itself cannot stand."*** And while we, like Lincoln, certainly expect *"the house will*

(316)687-2143 jyeskie@redstoneadv.com

cease to be divided and become all one thing or all another", we would suggest that all posturing to the contrary, the real question is not ***will*** they stop, but rather ***can they stop*?**

Figure 1



As we have steadfastly maintained for many years, **the solution *is* the problem**. The reality is that QE notwithstanding, the stabilizers have been relentlessly expanding the money supply through artificially low interest rates and the expedient use of the printing press for some time. Each time they are faced with the prospect of a debilitating **debt deflation** as a result of the collapse of yet another credit-induced speculative boom, the stabilizers follow the path of least resistance and pursue an inflationary **policy of postponement**. This evergreen expansion of credit has manifest itself in a seemingly never ending wealth-destroying cycle of **boom-bust-boom**. It was in fact the collapse of the stabilizers previous credit-induced bubble in housing that became the rationale for the implementation of the current destructive zero interest rate policy (ZIRP) and quantitative easing programs (QE) which are now fueling even more destructive bubbles in risk markets and underwriting ongoing fiscal profligacy. Increases in the money supply set in motion the Keynesian exchange of ***something for nothing*** which diverts real funding away from wealth generators toward the holders of the newly created money ***"out of thin air"***, thereby resulting in an increasing **polarization of wealth and income**. Through the manipulation of interest rates, the stabilizers interfere with the market process of price formation, setting in motion a debilitating **misallocation of resources**. One only has to consider the continuing intractability of the US housing market collapse to dispel any remaining doubts about the efficacy of credit-driven asset inflations to generate sustainable prosperity. Furthermore, real incomes fall as the monetary inflation depletes the real pool of funding through the misallocation of resources and the destruction of wealth, which if continued, may ultimately result in what we have described in our Third Quarter 2010 Market Review as a coming ***famine of income***. Still, the solution of choice remains the same, inflate to a *fare-thee-well*. Why is that?

The key to understanding the Fed's seemingly self-destructive behavior today, may be found in the past. Over the past 20-plus years, the Federal Reserve has undergone a marked transformation with respect to its role as mediator of financial crises, from a lender of last resort and a provider of liquidity, to a **price fixing mechanism** for both an economy and financial markets that have long struggled with severe structural dislocations. Shortly after his appointment as Federal Reserve Chairman, Alan Greenspan underwent a **"baptism by fire"** in October 1987 as **Black Monday** saw the US stock market fall nearly 23 percent in one day. Fearing a 1929-effect on both the financial markets and the economy, Mr. Greenspan was quick to reassure investors that the Fed stood ready to support the markets in an effort to ***"ward off financial paralysis"***. Over the next several decades, the **"Greenspan Put"** that was inaugurated in 1987 would be honed to perfection as the Federal Reserve pursued a limbo-like funds rate policy of ***"how low can you go"*** while careening from one crisis to another.

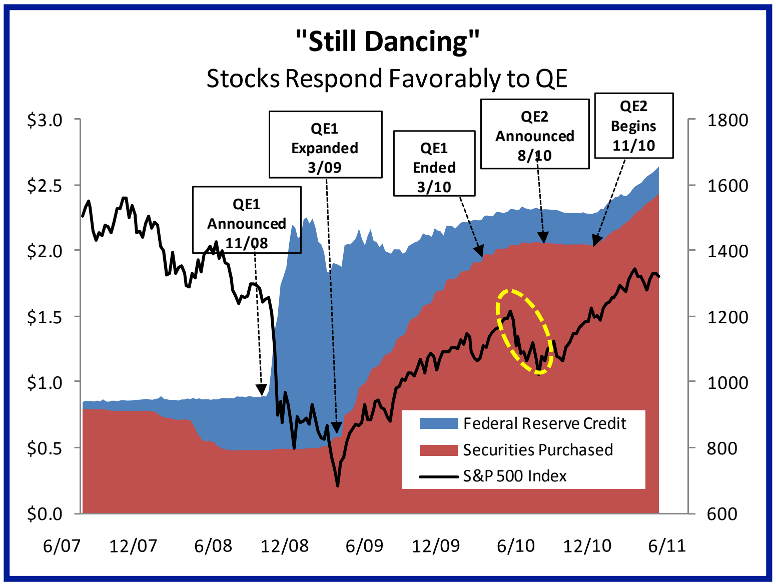
However in our opinion, the point of no return was breached in 1998 with the Fed-orchestrated bailout of Long Term Capital Management, a private, unregulated hedge fund ran by a collection of arrogant traders and noble-prize winning financial theorists. Over a five-week period in the fall of 1998, the ***"gang from Greenwich"*** went from mega-rich geniuses to discredited failures with the stunning collapse of their arbitrage trading strategy and the spectacular loss of the funds' $5 billion in capital. As a result, the imminent collapse of LTCM, whose $100 billion balance sheet had been levered to control over $1 trillion in notional derivatives exposure, threatened to drag down markets around the world. New York Reserve Bank President William McDonough justified the Fed's unprecedented involvement in the bailout by pointing out that with the collapse of LTCM, which was doing business with every major bank on Wall Street, foreign and domestic, *"markets would probably cease to function."* Never mind that it was Mr. Greenspan's tireless cheerleading for self-regulation of the derivatives industry, insisting that the power of self-interest would be sufficient to protect against systemic risk, which when combined with the Fed's artificially low interest rates and abundance of liquidity, enabled the misbehavior in the first place. Mr. Greenspan would write his ***mea culpa*** in 2008, feigning a *"state of shocked disbelief"* as he admitted he had discovered *"a flaw in his economic ideology."* In the mean time, the terms **"systemic risk"** and **"too big to fail"** (TBTF) would become permanently ensconced into the stabilizers lexicon. And so from the LTCM bailout, to the Great Recession and financial crisis of 2008-2009, the operation of monetary policy by the Federal Reserve has moved ever more stridently from **Bagehot's dictum** of freely lending to illiquid, but not insolvent institutions at a penalty rate, to what Artemis Capital Management recently described as *"writing a naked put on the entire financial system with margin backed by the US debt."* As a result, risk is no longer two-way for those deemed TBTF and markets no longer trade on fundamentals, but rather on the prospect for the continuation of intervention. Addressing himself to the topic of moral hazard, the English philosopher Herbert Spencer wrote; ***"The ultimate result of shielding men from the effects of folly is to fill the world with fools."***

In support of our assertion, we need only draw attention to the events of the last few weeks. In particular, the Fed's participation in a coordinated market-rigging operation to support the Japanese yen, clearly underscores the commitment by governments and central banks to do ***whatever is necessary*** to ensure that positions deemed ***"systemically significant"*** are not exposed to the risk of an uncontrolled reversal. The Fed's participation in the emergency G-7 intervention to prevent the Japanese yen from appreciating was triggered, not by concerns of a global deflationary shock emanating from a potential down-shift in Japan's GDP, but rather by fears that a rapidly strengthening yen would throw financial markets into a tail-spin as leveraged speculators who had borrowed massively in yen and invested abroad would be caught in a savage **short-covering squeeze**. Rather than taking the opportunity to re-introduce **two-way risk** in so-called risk markets, the stabilizers once again ***chose*** to bail-out the profligate, and by so doing, they, in the words of David Stockman, *"reassure the speculators that in the global financial casino operated by the world's central bankers, the house will always be there for them."*

Not unlike the Bank of Japan, the Fed's decades of unwavering commitment to a **policy of moral hazard** has made it hostage to the banking oligarchy and global speculative classes and as such, it now finds itself ***obliged*** to perpetuate the emission of stimulus each time a crisis rears its head in order to keep the *oh-so-necessary* bubbles rising. And without question the bubble that has been first among equals with respect to the stabilizers QE program has been the stock market. We know this because Chairman Bernanke told us so in his op-ed in *The Wash-*

ington Post on November 4; *"Higher stock prices will boost consumer wealth, help increase consumer confidence, and spur lending. Increased spending will lead to higher incomes and profits that, in a* ***virtuous cycle****, will support the economic expansion."* Towards this end, the Fed has been operating their QE program with this **virtuous cycle** in view. This relationship is highlighted by **Figure 2** which graphs the performance of the S&P 500 Index against the expansion of the Federal Reserve's Balance Sheet via their QE program. As we can see, after collapsing by nearly 60% between October of 2007 and March of 2009, stock prices began to rise in response to the massive expansion of security purchases under the Fed's QE1 program. Between March of 2009 and March of 2010, stocks rallied by **80 percent** as the Fed purchased nearly **$1.5 trillion** in mortgage, agency and Treasury securities. However, upon completion of QE1 and the cessation of security purchases by the Fed in March of 2009, stocks dutifully fell by 16 percent. The subsequent resumption of the rally in stock prices coincided with the **announcement** of a $600 billion QE2 program at the Fed's annual Jackson Hole speech in August of 2010. Stocks have continued to rally in step with the Fed's security purchases under the QE2 program. The correlation between stock prices and the expansion of the Fed's Balance sheet, at 87 percent, has very high during across the entire period. And while we are firm believers that correlation is not, in and of itself, proof of causation, as we have outlined in previous reports we firmly believe that the correlation illustrated in **Figure 2** *is* causally related. Setting aside for a moment the efficacy of the Fed's intentional targeting of stock prices to engender a **virtuous cycle** of wealth effects, the real question is what is likely to happen to stock prices should the Fed decide not to continue their program of quantitative easing after the completion of QE2. In response to this question, economist Jan Hatzius of Goldman Sachs coined a new phrase for use by those who believe that stock prices would respond negatively – ***"cliffing"*** – the idea being that if the Fed stops QE, the stock market will "cliff" and fall sharply lower. Sounding eerily prophetic today, we believe a quote by Citigroup CEO Chuck Prince made back at the start of the crisis in July of 2007, perfectly describes the situation; "*When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."*

Figure 2



Regarding the benefits of targeting asset prices in order to initiate the so-called ***"virtuous cycle"*** of wealth effects, we have dealt with this chimera in great detail in previous reports. Suffice it to say that the boom-bust-boom cycles underwritten by the stabilizers through the intentional manipulation of interest rates and credit expansion always leads to greater impoverishment. The deleterious impact of this process of impoverishment on households is aptly illustrated by **Figure's 3** and **4**. Referring to **Figure 3**, we can see that since the inauguration in earnest of the **"Greenspan/Bernake Put"**, household net worth as a percentage of disposable income soared to extremes during the twin bubble periods of 1998-2000 and 2004-2007 as the prices of both stocks and housing rose to unprecedented levels. In each instance however, with the implosion of the asset bubbles, net worth summarily collapsed as the **"wealth effect"** produced by the credit expansion, like the bubbles that underwrote them, proved to be merely ***"transitory"***, thereby negating any *beneficial* wealth effects. However, while the increase in household net worth occasioned by the stabilizers money printing operations ultimately proved to be **transitory**, the indebtedness that it produced did not. Referring to **Figure 4**, we can see that after having risen to crushing levels relative to income, the ratio of household debt to income is now undergoing what we fear will prove to be a ***"mean"*** reversion to the long-term trend. And while such a deflationary correction is both necessary and inevitable, to those who would point to this **"deleveraging trend"** as proof the household sector has improved and again stands ready to borrow its way to prosperity, we would suggest that as always, the ***"devil is in the details"***. Referring to **Figure 5**, we can see that since reaching a peak of **130 percent** in 2007, the reduction in the ratio of household debt to income has primarily come about, not from the modest reduction in indebtedness, but from an increase in disposable income of around **8.4 percent**. Unfortunately this gain in disposable income does not reflect an improved debt servicing capacity within the household sector, but rather the effects of a multi-year Keynesian **"tax holiday"** and **"transfer payment windfall"**. Since 2007, personal taxes are down roughly **3 percent**, while transfer payments are up around **5.4 percent**. Clearly these two trends cannot continue as Federal tax revenues, which have collapsed to around **15 percent of GDP**, the lowest level since 1950 and well below the long-term average of 20 percent, will need to rise in the years ahead. While the surge in transfer payments, mostly driven by **extended unemployment benefits**, will be flat or falling going forward. And if that is not sobering enough, according to an analysis by the Fiscal Times, for the first time since the Great Depression, US households in 2010 received more in cash handouts from the government ($2.3 trillion) than they paid in income taxes ($2.2 trillion). All of this strongly suggests that the necessary deflationary correction to household spending has yet to take place, thereby increasing the systemic risks associated with an immediate withdrawal of stimulus. As such, not only has there been no

Figure 3

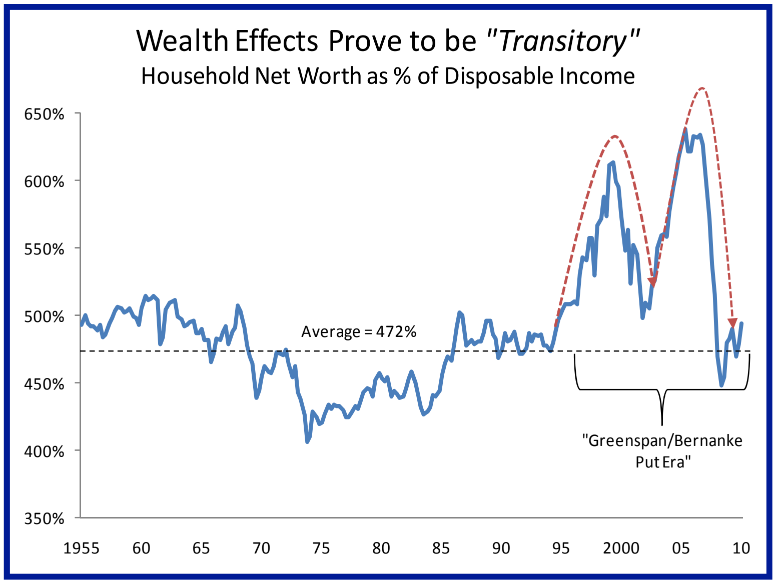
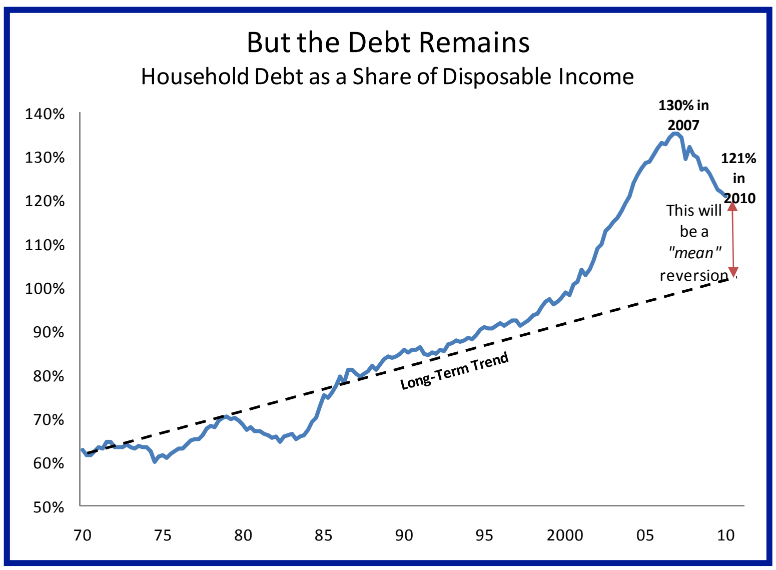


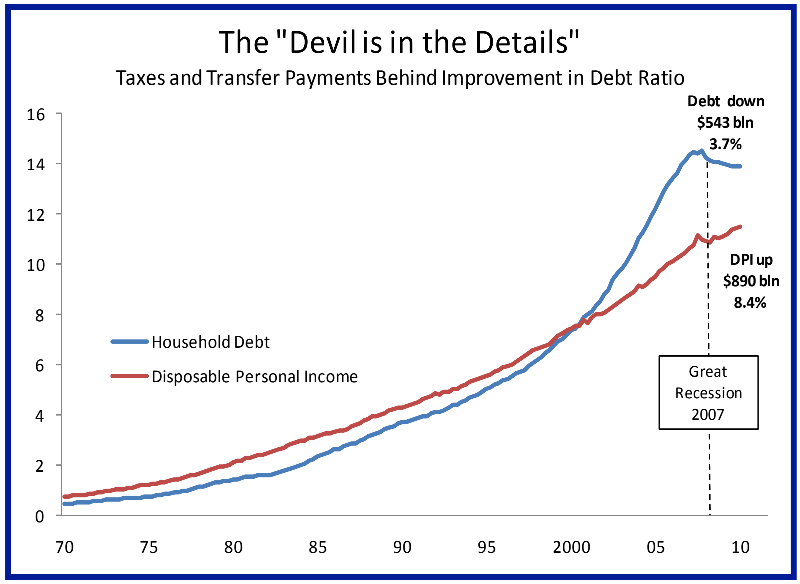
Figure 4



"virtue" in the *virtuous cycle* so sought after by the stabilizers, there is no prospect of any either. To paraphrase political theorist Ernest Lefever, the real **irony of virtue** is that *"virtue untempered by **facts**, will ultimately lead to disaster"*.

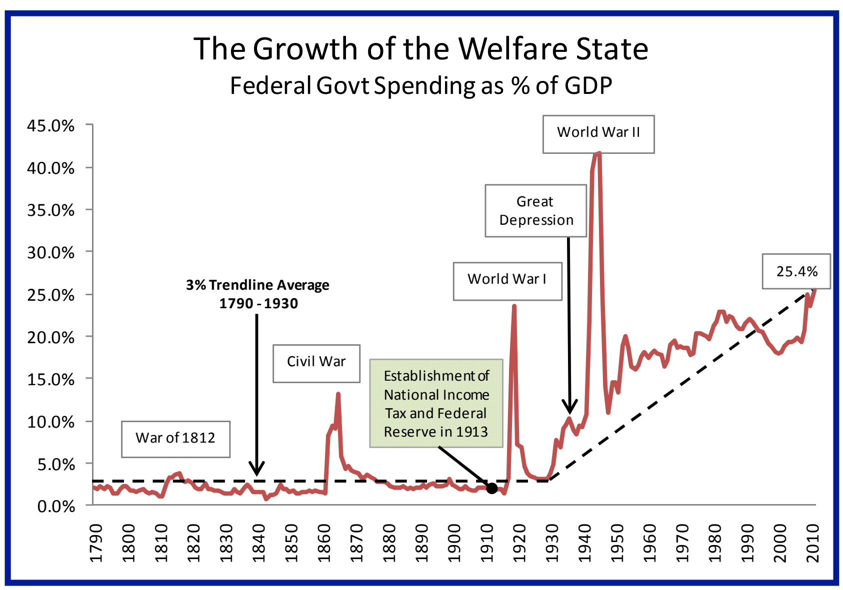
And in fact, it is a potential disaster that we now face. Not from the cessation of quantitative easing, though certainly that path, if chosen, will involve a substantial amount of discomfort and dislocation, but rather from its continuance. The real issue we face is our **fiscal disorder** and the **stabilizers role** in the perpetuation of that dysfunction. Our country is in dire financial trouble and our current path of fiscal profligacy is simply **unsustainable**. The statist ideology which now prevails, offers but one response – the expansion of government and with it, a culture of dependency. After all, to a hammer, all problems look like nails. Referring to **Figure 6**, we can see the dramatic change that has occurred in our country's finances since its founding. From 1790 to 1930, government spending on average accounted for just **3 percent** of GDP. Today government spending absorbs over **25 percent** of GDP. Yet it is not the growth of the welfare state per se that now threatens us, but the **colossal debt** we have amassed to underwrite the expansion.

Figure 5



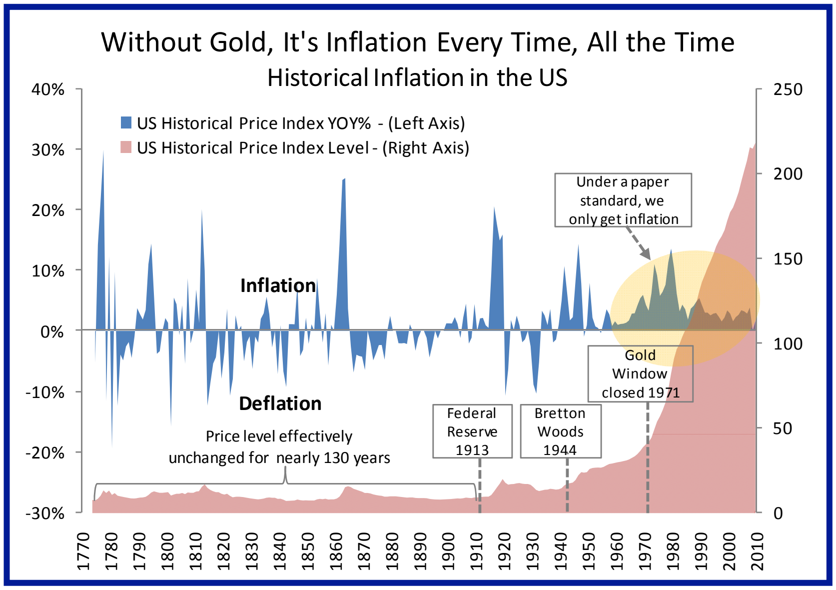
As we have maintained for years, **convertibility** under the gold standard ensured **monetary restraint** and prohibited the unlimited expansion of government. In the words of the French economist Frederick Bastiat, *"government cannot have any other rational function but the legitimate defense of individual rights."* However, as the 19th century came to a close, so too did the libertarian ideals which had prevailed since our country's founding. With the establishment of the Federal Reserve and a national income tax in 1913, the era of laissez-faire gave way to the growth of the welfare state and a new era of economic planning. Bracketed by two world wars, the Great Depression launched an unprecedented enthusiasm for the **ethics of redistribution** and the attainment of the

Figure 6



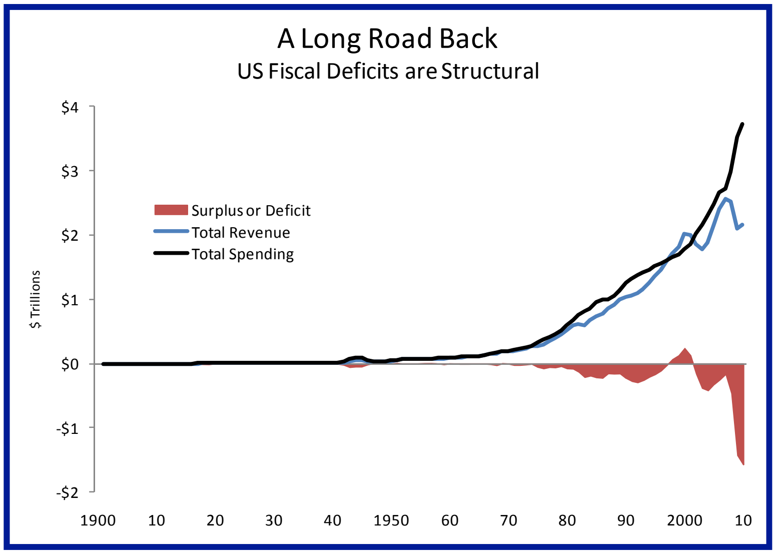
"public good" through interventionism. In retrospect, we can see that the real reason for the abandonment of gold was the elimination of the restraint it imposed on the expansion of government through monetary inflation. Referring to **Figure 7**, we can see that for that period of time when the US was subjected to the discipline of gold, periods of inflation regularly alternated with periods of deflation as measured by the YOY change in the price index. On average, the price level was effectively unchanged as reflected by the non-accelerating trend in the price index. The period between the creation of the Federal Reserve in 1913 and the closing of the gold window in 1971, was a period of transition during which convertibility was greatly diminished. However, with the closing of the gold window and armed with the **"exorbitant privilege"** of being the world's sole reserve currency, the US was free to pursue a policy of "guns and butter". Interestingly, under the guise of pursuing **"stable prices"**, inflation in the paper era has only gone one way – up! In fact, as we have outlined previously, since under a paper standard, **all money is debt**, positive monetary inflation is not just desirable, it is absolutely essential in order to avoid a credit deflation which is simply a contraction of money. As such, inflation, which is merely theft by deception, is the only policy tool available to the stabilizers. Ironically, it was the father of modern day interventionism and inflationism, Lord Keynes, who aptly described the indispensible role played by inflation in the expansion of government; *"By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens."* Nevertheless, it was Bastiat who explained the bargain; *"To rob the public, it is necessary to deceive them. To deceive them, it is necessary to persuade them that they are being robbed for their own advantage."*

Figure 7



Clearly the advantage which the public hoped to secure in exchange for their enthusiastic participation in the ***'something for nothing'*** swindle was the fiction whereby through the redistributive efforts of the government, everyone can enjoy a higher standard of living at the expense of everybody else. It is for this reason that today, we find ourselves faced with the cumulative cost of that *'higher standard of living'* in the form of massive **unfunded future liabilities**. We are literally steaming toward a veritable iceberg of unfunded liabilities which have been conservatively estimated at **$44 trillion** by Mary Meeker in her comprehensive summary of America's financial condition entitled ***'USA Inc.'***. When added to the current level of public debt already issued, the total is nearly **$60 trillion**. In many ways, the $14.3 trillion in current outstanding public debt is equivalent to Bastiat's *that which is seen*, it is the proverbial **tip of the iceberg**, while the vast majority of the threat, which is just as real, remains *unseen*, still safely submerged from our radar screen with the only thing separating them being the mere passage of time. This is the chief danger and the critical point to apprehend from Ms. Meeker's work, that no action whatsoever is required for *that which is unseen* to become *that which is seen*. When juxtaposed against this coming cataclysm, the current partisan budget debate over a meager cut of $10, $30 or even $60 billion is tantamount to ***rearranging deck chairs on the Titanic***.

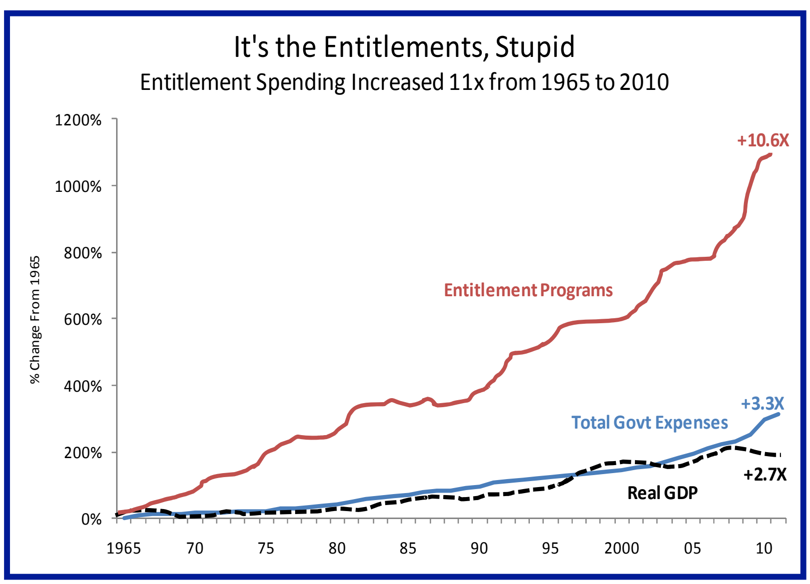
Figure 8



Despite public perceptions to the contrary, the US fiscal deficits are **structural**, not cyclical. By this we mean that they are the result of government consistently spending more than it takes in and as such, the deficit remains regardless of the economy's position in the economic cycle. This is highlighted by **Figure 8**, where we can see that with the exception of the four-year period between 1998 and 2001, total spending has exceeded total revenue by an ever increasing amount. The modest improvement over that four-year period is entirely attributable to an increase in the collection of capital gains taxes resulting from the Nasdaq stock bubble, not a reduction in spending. Given that government revenue historically has closely tracked real GDP growth, the road back to fiscal sanity will be, at best, long and arduous.

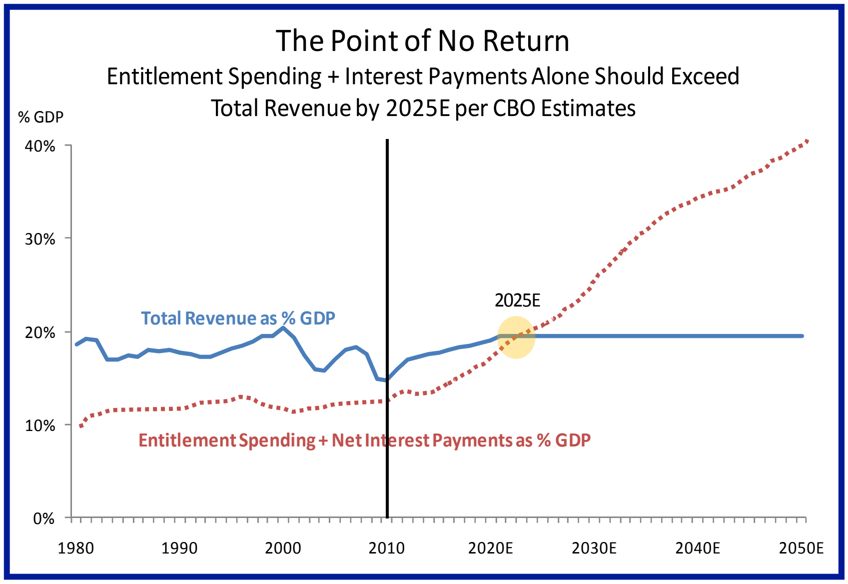
The primary culprit of our fiscal imbalance has been the unprecedented growth of **entitlement programs**. Since the Great Depression, the US has consistently added what Ms. Meeker calls **"business lines"**, and despite the fact that recessions come and go, the claims stemming from these new business lines have continued to increase. However, apart from Social Security and unemployment insurance which have **dedicated funding sources**, Congress, which has been quick to secure voter enthusiasm with government programs, has been criminally negligent in its responsibility to raise the requisite revenue to fund them. As a result, funding for all other entitlement programs has been woefully inadequate. Consider that over the past 15 years, real entitlement spending has risen by **170 percent** while dedicated funding for those programs has only risen just **70 percent**, resulting in an annual **entitlement deficit** in excess of more than **$1 trillion annually**. Referring to **Figure 9**, we can see that since 1965, total spending on entitlement programs in the US has increased nearly **11-fold** while real GDP and total government expenses have increased only **3-fold**. For FY 2010, entitlement spending totaled just under **$2 trillion**, representing fully

Figure 9



58 percent of the $3.5 trillion in total government spending making entitlement spending the **"elephant in the living room".** Recalling a recent cartoon we saw characterizing the partisan response to the current dysfunctional state of government finances, we here repeat the tagline; *"You're right Jenkins, the numbers don't lie. Get me some that do."*

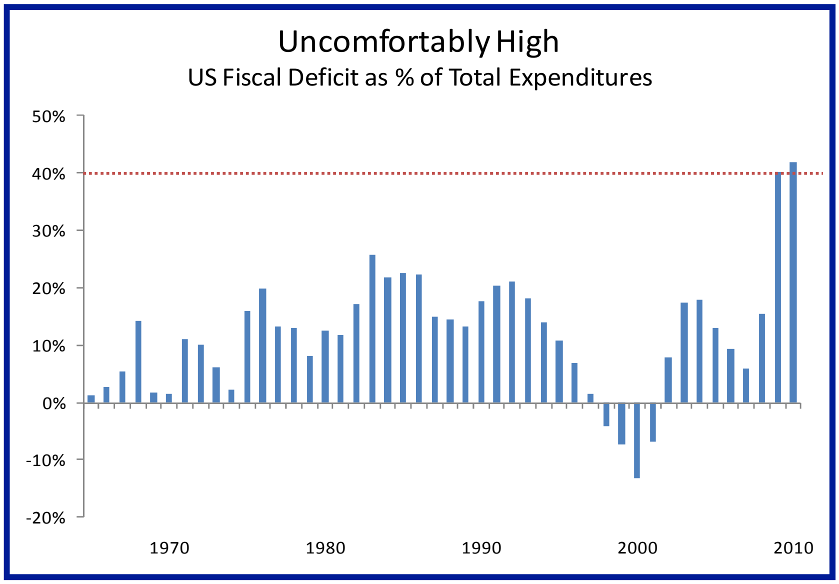
Figure 10



While the numbers may not lie, they can change. We now learn that based on current forecasts for revenue and expenses from the Congressional Budget Office or CBO, by **2025**, or in **less than 15 years**, the combination of total entitlement spending plus interest on the debt will exceed total federal revenue. (**Figure 10**) However, just ten-years ago in 1999, the CBO projected that federal revenue would support entitlement spending and interest payments **until 2060** – ***35 years beyond their current projection***. The marked acceleration of this theoretical **"point of no return"** underscores the importance of addressing the issue of entitlement reform while there is yet time. For as a result of the massive expansion of government and the culture of dependency it has engendered, today more than **35 percent** of the US population receives **entitlement dollars** or is **on the government payroll**, up from just 20 percent in 1965. For this reason, personal savings rates have plunged as an ever larger proportion of the population has come to depend upon the government for its 'savings' and healthcare needs. The current environment of **low personal savings** coupled with **high structural employment** will make the radical changes required, politically difficult. For as President Reagan once wisely observed; *"The nearest thing to eternal life we will ever see on this earth is a government program."*

However, the trillions in new debt issued by the federal government in the past several years have not been financed out of savings, either foreign or domestic. Instead they have been largely absorbed by the Federal Reserve and other foreign central banks. For the two-year period beginning with the expansion of QE1 in March of 2009 and ending in March of 2011, the US public debt outstanding has increased by approximately **$3.3 trillion**. During that same period, the Federal Reserve purchased over **$1 trillion** in US Treasury securities directly, while purchasing another **$1.5 trillion** in MBS and GSE Agency debt, for a total of **$2.5 trillion** in security purchases under its QE programs. And while it cannot be determined with certainty, the Fed's Flow of Funds report suggests that those who were sellers of MBS and Agency securities to the Fed were also buyers of Treasury debt. Under that reckoning, the Fed effectively **monetized** nearly **75 percent** of the US fiscal deficit over the past two years. And as history has demonstrated time and again, the **monetization of a nation's fiscal incontinence** is the surest road to perdition. According to Tanzi's Law, *"Hyperinflations are always caused by public budget deficits which are largely financed by money creation.* And according to Professor Peter Bernholz who has examined 12 of the 29 hyperinflationary episodes where significant data exists, history suggests that fiscal deficits amounting to **40 percent** or more of total expenditures cannot be sustained for long and those countries that attempt to do so are at risk of a **hyperinflation**. Referring to **Figure 11**, we can see that for the fiscal years ended 2009 and 2010, the US deficit has been uncomfortably high at levels of approximately **40** and **42 percent** of total spending, respectively. And while the US clearly has the unique advantage of controlling the world's sole reserve currency, and as such can print as much currency as is required to meet its debt service obligations, we would do well to consider the limit implied by Edward Altman, Finance Professor of New York University's Stern School of Business; *"You are never broke as long as there are those who will buy your debt and lend money to you."*

Figure 11



But therein lies the problem for very soon (June 30th), the **"bid"** of the stabilizers is scheduled to go silent. And given the situation as we have described it in this report, such a silence has the potential to thunder across the financial markets. At the same time, Japan may need to slow or discontinue its purchases of US Treasury debt as it deals with the aftermath of the quake and tsunami. China will also likely have a reduced appetite for US debt as it attempts to slow inflation and suppress the speculative bubbles that now confront its economy. In fact China's central bank recently announced plans to diversify its over $3 trillion in foreign exchange reserve holdings, as foreign reserves *"have exceeded the reasonable levels they actually need."* Such an announcement almost certainly portends a reduction in US Treasury purchases going forward. And although fiscal restraint tends to deliver stable debt, it rarely produces substantial reductions to the debt outstanding. And while swings from deficits to surpluses have tended to occur with either falling interest rates, rising real growth, or both, today interest rates are exceptionally low and the growth outlook for advanced economies is modest at best. Therefore, given that the US fiscal condition is unlikely to improve substantially in the short-term, we are faced with the unsalutary prospect of a increasing supply against a background of reduced demand.

There is a Chinese proverb which says; *"When you drink the water, remember the spring."* And we have clearly been drinking the **"Kool-Aid"** in the form of QE, both deeply and for an extended period of time. For many years we have been calling attention to the evils of both inflationism and interventionism, and the specific role played by the stabilizers in their pursuit. As such, it is important to take note of Professor Bernholz's warning regarding the participation of monetary authorities in a nations' fiscal misbehavior; *"Hyperinflations ultimately are caused by irresponsible and profligate legislatures that spend far beyond their means, **aided and abetted by accommodative central banks**."* Holding to the truth that gradualism in theory is perpetuity in practice our current situation demands that we make a radical break. In Robert Frost's poem, he spoke of two paths. **Clearly it is time to take the road less traveled**.