Redstone Advisors

Economic and Market Review

First Quarter 2013

"We do not have knowledge of a thing until we have grasped its why, that is to say, its cause."

Aristotle

"The phenomena of the social economy have likewise their efficient cause, and their providential intention. In this department, as in natural science, as in anatomy, or in astronomy, men have frequently denied the final cause precisely because the efficient cause assumes the character of an absolute necessity."

Frédéric Bastiat, French Philosopher and Economist

It was Benjamin Franklin who once said; *"In this world nothing can be said to be certain, except death and taxes."* Alas, but it would appear that to death and taxes we must now add a new certainty; an imminent rise in long-term interest rates. Such, at least, is the pronouncement of many experts of late, and in particular no less an eminent prognosticator than Dr. Martin Feldstein, Professor of Economics at Harvard University and President Emeritus of the National Bureau of Economic Research. Dr. Feldstein, who on March 30, 2013 penned a commentary for Project Syndicate with the unpretentious title of 'When Interest Rates Rise', declared the impending rise in rates to be not just certain, but a veritable *fait accompli*. We quote here the opening paragraph from his article in full:

> *"Long-term interest rates are* **now unsustainably low**, *implying bubbles in the prices of bonds and other securities.* **When interest rates rise, as they surely will**, *the bubbles will burst, the prices of those securities will fall, and* **anyone holding them will be hurt**. *To the extent that banks and other highly leveraged financial institutions hold them, the bursting bubbles could cause bankruptcies and financial-market breakdown."* [Emphasis ours]

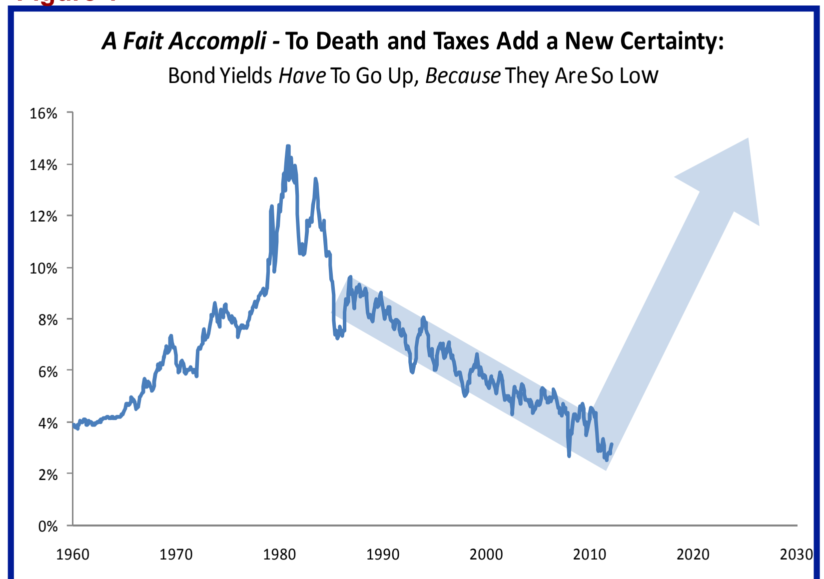
"As they surely will" and *"will be hurt"* has the ring of inevitability to it. It is to say that the thing is certain, the prophecy is sure. Yet is it prophecy or is it propaganda? Some things that are certain do not require a formal proof. We would say they are self-evident; That all men are created equal and endowed by their Creator with certain inalienable rights comes to mind. Others, while no less certain, are not self-evident and as such, do require formal proof. Consider Newton's Laws of Motion or of gravity for instance. What goes up, *"surely will"* come down. Yet why must it come down? Not because it is self-evident, but because as Newton discovered there is a force acting on it, an unseen force in the form of a natural law. In other words there is an efficient **cause**. And as our opening quote from Aristotle reminds us, until we understand a things cause, we do not yet understand that thing. It is therefore insufficient to declare a thing certain without first establishing the cause which makes it so.

But what **cause** does Dr. Feldstein or any of the professional econometricians offer to establish the certainty of their claim that long-term interest rates must rise? As we highlighted in the excerpt from Dr. Feldstein's article, interest rates must rise because they are *"now unsustainably low."* Interestingly this is the same **"non-cause"** offered by a plethora of experts of late. In a recent article in Investment News entitled 'Fear Rising With Rates', the reason given as to why interest rates must rise is that *"they have been falling for so long."* Another expert, Ankur Shah of the World Money Analyst recently stated; *"**Given** the unprecedented* [low] *level of yields on US Treasuries, we are, in my view, close to the end of the secular bull market in government bonds."* And yet another expert with Guggenheim Partners said; *"**Given** where rates are today, the risk to rates is clearly to the upside."* [Emphasis ours] In each instance the only cause **"given"** as to why rates must rise is because they are so low. While Newton's Law of Gravity dictates with apodictic certainty that what goes up will come down, we are not familiar with any law which mandates that what goes down must of certainty go up. And more to the point, we are not aware of any law, natural or

otherwise, which autonomously governs the behavior of interest rates. The movement of interest rates is always and everywhere grounded in an efficient cause. Ultimately, there are several arguments that can be made as to why interest rates *could* rise and we intend to review these. However to insist that bond yields *must* go up simply because they are so low is no argument at all. At best it reflects intellectual laziness of the first order, subsisting solely as a guess. An educated guess perhaps, but a guess nonetheless. At worst it reflects the dissimulation of talking one's own book, i.e., propaganda. Speaking to the limits of mortal omniscience and its pragmatic solution, computer scientist Alan Kay once said; *"The best way to predict the future is to invent it."*

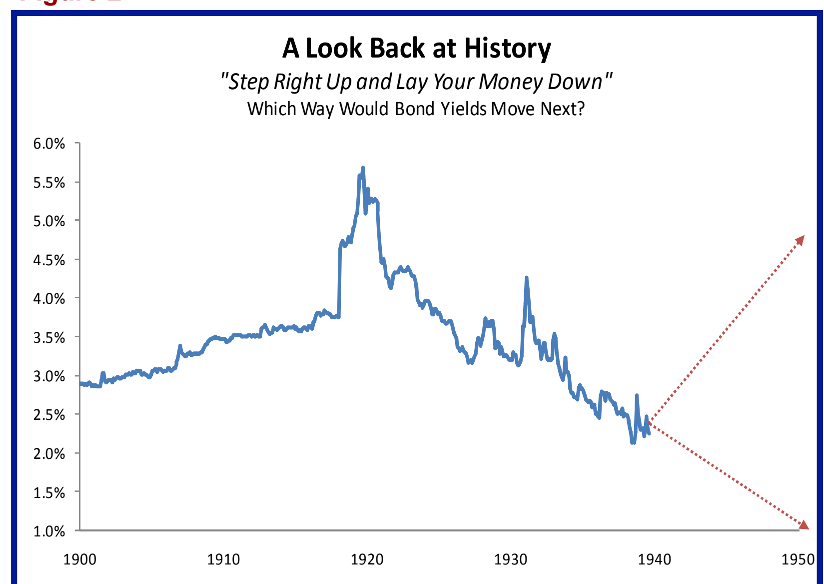
Certainly the argument invented by the fraternity of 'rate-risers', the uncaused obligation laid upon interest rates to go up just because they are so low, is as the idiom suggests, the offspring of necessity. This "necessity" may be visualized by the chart in **Figure 1**. Not unlike a powerful subliminal suggestion, this stylized presentation of long-term interest rates, replete with its symmetry of rising and falling, and by implication, soon-to-be rising rates, certainly suggests an aspect of inevitability. Anything less would seem a violation of some innate property of interest rates, evoking in the reader perhaps the mysticism of mean reversion or maybe the inexorable cyclicality of history, the kind we are doomed to repeat. Either would be equally offensive to one's sense of justice and proportionality. To the uninitiated, mesmerized by the sheer symmetry of the data, surely nothing could be more natural or more necessary than a sharp, extended rise in interest rates to compliment the two preceding long-term trends.

Figure 1



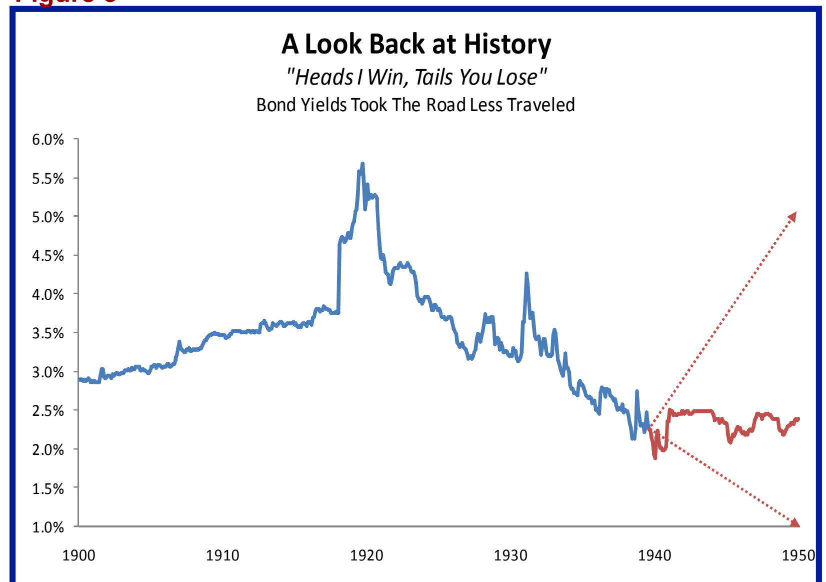
For the sake of illustration, let us for a moment descend into the role of the carnival barker and play along at such a game. We too can stylize a presentation of interest rates for the purpose of suggestion. In **Figure 2**, we present the same series of long-term interest rates for the fifty years ***prior to*** the fifty-year period covered in **Figure 1**. We have, however, intentionally left out the ten-year period which connects the two charts into one continuous 110 -year period. Notice that though they differ markedly in scale, the two periods are remarkably similar in both symmetry and proportionality. Long-term rates first rise for twenty years, reach their apex, and then dutifully fall for twenty years. Under the same rationale imposed by the rate-risers, clearly the next major move in interest rates in **Figure 2** would be a long-term rise in rates. But which way, in fact, did rates go? Drum roll please.

Figure 2



In the immortal words of Gomer Pyle; ***"Surprise, surprise, surprise!"*** Looking at **Figure 3** which includes the missing decade in red, we can see that bond yields neither rose nor fell, but instead *took the road less traveled* and trended sideways for over ten years. So much for stylized interpretations of history and the implied law of uncaused inevitability. As it turns out, Plato was right; *"Necessity as the mother of futile dodges, would be much nearer to the truth."*

Figure 3



But why would a rise in long-term interest rates be a *necessity* for some prognosticators? Perhaps because they dogmatically adhere to a quantitative discipline and like good chartists are obliged to follow the trend revealed by momentum and correlation. Under the correlation-as-causation approach, the independent data series assumes the role of the *de facto* efficient cause. Shackled by the empirical rules of statistics, *"this efficient cause"*, in the words of Frédéric Bastiat, *"assumes the character of an absolute necessity."*

Unfortunately for the *correlation-as-causation crowd*, the question of causality is never addressed. In fact as John Hussman of Hussman Funds has pointed out, *"the correlation of any two data series will be nearly perfect is they are both rising diagonally."* To drive home his point, Mr. Hussman has noted that *"since 2009 there has been a 94 percent correlation between the price of beer in Iceland and the S&P 500 Index."* While the correlation is *nearly perfect*, surely no serious investment professional is ready to suggest that any causality exists between the two data sets. This blind side to quantitative economics was long ago identified by the Austrians and succinctly summed up by Murray Rothbard; *"Gazing at reams of statistics without prejudgment is futile."* In other words, data can never address the issue of causality. One must begin with a proper philosophy of how the world works, for *"principles",* as Basitat once observed, *"are merely formulas for classifying facts."*

Still another reason that a rise in interest rates could be a necessity for some may be found by reading *between the lines*. In the previously mentioned article, 'Fear Rising With Rates', we find a composition loaded with innuendo pitched to evoke fear among bond investors. Consider two representative quotes from the article;

"The public thinks bonds are safe, but they're not. They have no idea what's about to happen to them."

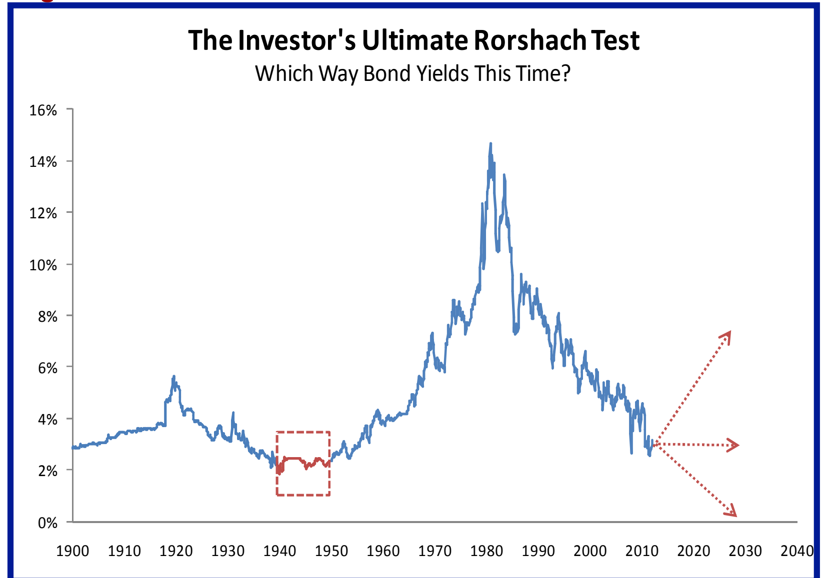
"Buyer beware. It's not going to be pleasant when rates go up."

Why all the fear mongering? Read on Macduff. After noting that over the past five years, *"net inflows into bond funds topped $1 billion, while outflows from stock funds totaled $421 billion"*, we later read that according to a recent survey of more than 300 financial advisers, *"a majority of advisers (57%) said they intend to advise clients to decrease their fixed-income allocations this year."* We leave the reader free to draw his own conclusion but one thing *is* certain; the difference in the vested interests of fee-based versus commission-based advisers is a *clear and present danger*.

Owing to the principle of *ex nihilo nihil fit*, which is translated as ***nothing comes from nothing***, we can be confident that there is no such thing as an **uncaused effect**. As such we now turn our attention to the real world problem of identifying economic cause and effect. Referring to **Figure 4**, we have consolidated our two stylized charts into one continuous history of long-term interest rates in a kind-of investors ultimate **Rorshach Test**. It is

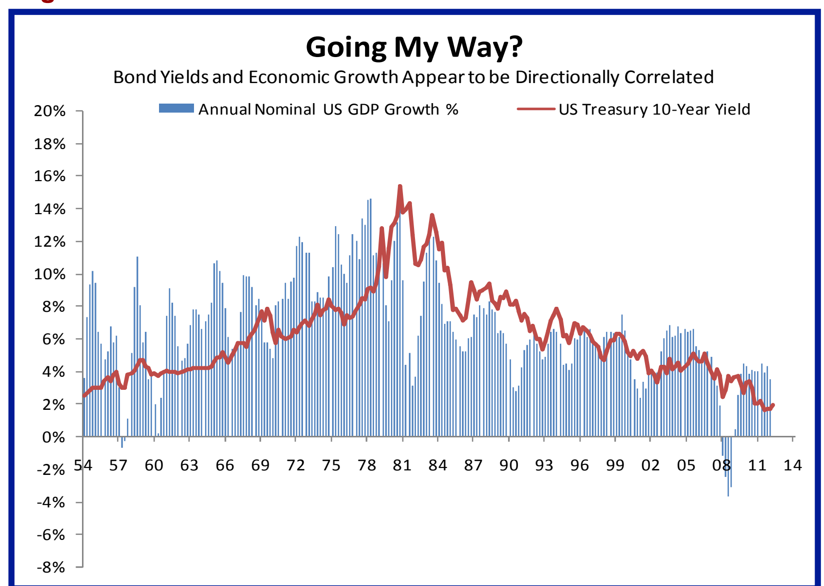
against this backdrop that we now pose the question; **What might actually cause long-term interest rates to rise sharply as conjectured by the experts?** And while we do not represent our list of possible causes as exhaustive, nevertheless by addressing what we believe are the most plausible causes, we find ourselves engaged in an unintentional defense of bonds that might best be described by a parody on the movie title; *Dr. Stangelove or: How I Learned to Stop Worrying and Love the "Bond"*.

Figure 4



According to the Keynesian consensus, the primary "cause" which would result in sharply rising long-term interest rates would be an increase in **economic growth** or more particularly an expectation of rising inflation due to economic growth. The Keynesian camp maintains there is a relatively stable and predictive relationship between economic growth and nominal bond yields. This relationship, they claim, is fairly straightforward suggesting that as economic growth accelerates or decelerates so will **inflation expectations**, thereby causing bond yields to rise or fall in order to maintain the normative **real yield or return** demanded by investors, often labeled the **"bond vigilantes."** This proposed relationship between economic growth and nominal bond yields is illustrated in **Figure 5**, and as we can see, based solely on a visual inspection of the data, there does appear to be some directional correlation between nominal GDP growth and bond yields for the period under review. However, the actual statistical correlation for the entire period of time covered in **Figure 5** has been quite weak, running at around 62 percent when calculated on a rolling 5-year basis. When calculated on a rolling 1-year basis, the correlation falls to 48 percent or effectively random. No doubt the correlation statistic could be improved through the addition of "lag times" between the two variables. Nevertheless, while over long periods one might suggest that nominal GDP growth and nominal bond yields have *tended* to move in the same direction, clearly there have been extended periods of time when they did not, **particularly over the short-run**, severely diminishing the proposed causative link between economic growth and interest rates.

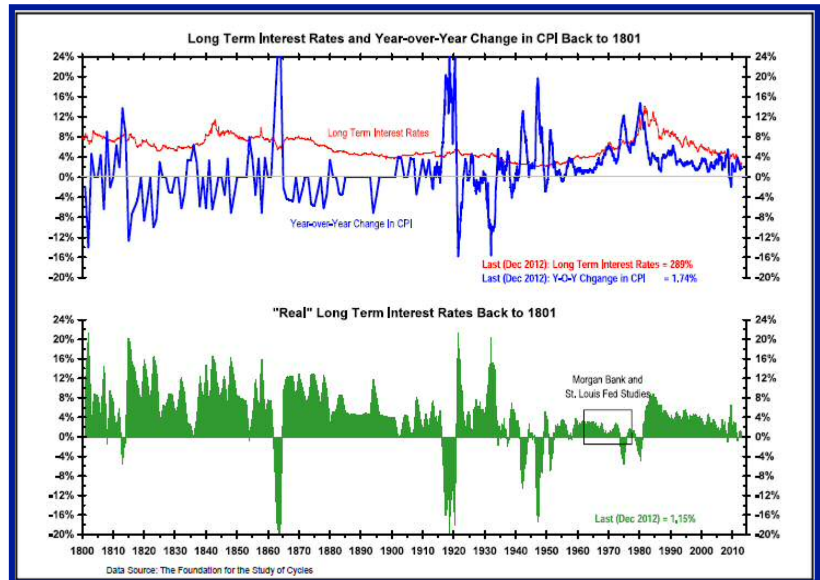
Figure 5



These departures between nominal GDP and interest rates are more noticeable when we concern ourselves with the primary transmission feature of this proposed relationship, inflation. Referring to **Figure 6**, which is a graph of long-term interest rates and the year-over-year change in CPI going back to 1801 created by Bianco Research, we can see that there is virtually **no relationship** between the change in inflation as measured by the CPI and long-term

interest rates for the period under review. This lack of correlation is highlighted by the extreme volatility of the bottom chart in **Figure 6** which graphs the difference between the two series, the hypothesized **normative real interest rate** demanded by the bond vigilantes. Judging from the chart, it would appear that the vigilance of the 'vigilantes' must be of the **tidal kind** - *'it comes and it goes'* - as even a cursory review of the historical real yield for the two-hundred plus year period under review underscores the fact that the relationship between inflation and long-term interest rates has been extremely volatile and anything but stable or predictive. In fact there is not even any directional relationship until the mid-1960s, coinciding with the impending breakdown of the dollar-centric Bretton Woods monetary system. Importantly, it is not coincidental that it is only from this point forward, the period of the initiation of our current fiat or paper monetary system, that inflation and interest rates appear to become directionally correlated.

Figure 6



Unfortunately for mainstream Keynesian prognosticators, despite the near universal acceptance of a causal relationship between expected economic growth and long-term interest rates, Keynes' original General Theory holds that the order of causation is reversed. According to the gospel of Keynes, interest rates determine (cause) the levels of saving and investment. To further compound error, Keynes also erroneously held that savings and investment are two entirely separate processes, performed by two sets of people with little or no link between them. As such the long-standing "classical" identification of saving and investment as being two sides of the same coin was, by the stroke of a pen, overturned. (We will not point out here the inconsistencies in Keynes' General Theory where he arbitrarily moves back and forth in his definition of savings and investment, at one point defining them as the same thing, while later on speaking of them as separate and non-related) Savings, according to Keynes, results in a "leakage" out of the consumption-spending stream, and is therefore bad. Investments, which mythically pour in from some other source, are held to be conducive to spending, the Keynesian equivalent of economic growth, and as such are labeled good. The task of good government, according to Keynes, is to stimulate investments and discourage savings, so that total spending increases. How is this to be done? It follows that it is only necessary for government to lower the market rate of interest and thereby encourage investment and *ipso facto* increase economic growth, while at the same time discouraging savings and its debilitating impact on economic growth through "leakage". Confused? Don't be, even a tried and true Keynesian acolyte like Paul A. Samuelson suggests that the obscurities and contradictions of the General Theory are an embarrassment for the anti-Keynesians rather than for the Keynesians. According to Samuelson; *"It bears repeating that the General Theory is an obscure book so that would-be anti-Keynesians must assume their positions largely on credit unless they are willing to put in a great deal of work and run the risk of seduction in the process."*

That the stabilizers, armed with Keynes' dogma, have been intentionally manipulating the market rate of interest in an attempt to manage economic growth is beyond debate. What they have achieved, on the other hand, is a matter capable of question. Nevertheless the important point is that savings and investment are in fact, causally related to interest rates. However it is not, as suggested by the Keynesians, the interest rate that determines savings and investment, it is rather the other way around -- the market rate of interest is determined by the supply of and the demand for savings and investment. Or at least it would be absent the persistent heavy-handed interference by the stabilizers. In today's fiat-money regime, money is produced through the creation of bank circulation credit. This, as

we have often remarked, is money creation *ex nihilo* -- literally out of thin air -- resulting in a rise in the supply of money that is not backed by real savings. The increase in bank circulation credit necessarily causes the market rate of interest to fall level below that of the natural interest rate, that is the rate which would prevail if there had been no expansion of credit. The artificial lowering of the market rate of interest induces additional investment while at the same time, savings decline and consumption increases. This sets into motion the boom-bust cycle that has increased in both frequency and severity over the past several decades. By increasing the money claims against existing wealth without a commensurate increase in the means of production through real savings, the economy is continually impoverished due to the destruction of wealth through increased consumption, speculation, malinvestments and the diversion of wealth in the form of debt service to the holders of the new fiat money. This, as we have often stated, is the real legacy of the stabilizers policy of postponement -- a **successful failure**.

As a result, both the US and most western developed economies are mired in the current economic malaise. This condition, which we have characterized as one of a **rolling recession** consisting of persistent below-potential economic growth, intractable structural unemployment, exponential growth in unproductive debt, chronic fiscal deficits, and a massive systemic famine of income due to the ongoing redistribution of wealth, is **structural** not cyclical. It represents the distortive impact of the culmination of over 40 years of impoverishment due to increasing intervention and monetary inflation underscoring our stubborn assertion that the **solution remains the problem**. During this period, the US economy has been transformed from a market economy to a mixed economy whose wealth creation is limited and whose wealth distribution is skewed in favor of the vital few over the trivial many. Unfortunately as we outlined last quarter, in our opinion the prognosis for achieving near-term self-sustaining economic growth is even more dire as an already eviscerated economy faces yet other perils in the form of significant headwinds including demographics, rising inequality, globalization, an educational deficit and diminishing returns from innovation. In the words of the satirist Tom Lehrer; *"But apart from that, Mrs. Lincoln, how was the play?"*

So while classical economics correctly posits that there is a real causal relationship between economic growth (savings and investment) and long-term interest rates, due to the wholesale acceptance of Keynes 'fatal idea', that relationship has been effectively suborned by the heavy handed intervention of the stabilizers. As such, under the current regime of a planned economy and managed markets, the primary determinant of long-term interest rates is . . . . wait for it . . . . short-term interest rates. This is because short-term interest rates are explicitly determined by the policy of the central planners. Therefore what is of critical importance to the question of an efficient cause for a rise in long-term interest rates is not economic growth *per se*, but rather the probability that the stabilizers policy of inflation and intervention can "cause" an increase in organic economic growth which would require them to end their policy of purchasing Treasury and mortgage bonds via quantitative easing, thus signaling their intention to reverse course and raise short-term rates above zero. To this question, our answer is unequivocal: **LOL**.

One way of evaluating the probability of future success by the stabilizers is by reviewing the efficacy of their previous operations. Towards this end, we have reproduced two charts originally created by Dr. Edward Leamer, Professor of Economics and Statistics at UCLA and the Director, UCLA Anderson Forecast. The first chart (**Figure 7**) graphs the cumulative rate of growth in real GDP as measured from peak to peak, for each of the **first eight recessions following WWII**, while the second chart (**Figure 8**) measures the **last 3 recessions since WWII**. Each recession is indexed to a starting value of 100 representing the cycle peak or the start of each recession. As such we can track both the depth of the recession from the peak of each business cycle, and its associated recovery. The X-axis measures the length of each cycle, peak to peak, in quarters. Additionally both graphs contain a trend line which represents 3-percent annual growth, a proxy for the long-term historical average of real economic growth. (The actual long-term growth rate has been 3.1%) As such we can readily see how many quarters it took each cycle to fully recover from the losses of the recession and return to trend growth, if at all, by observing when each line crosses the 3-percent trend line.

Referring first to **Figure 7** which depicts the **first eight recessions since WWII**, we notice a similar pattern for all recessions except the brief recession of 1980. Beginning with the cycle peak at time zero, economic growth falls below zero or the horizontal axis as we enter the recession. We then observe a period of **super-normal growth**

which at some point causes each line to return to and exceed the 3-percent long-term growth trend, signaling a complete recovery of the economic growth lost during the recession. Referring to **Figure 8** which depicts the **last three recessions since WWII**, a completely different picture emerges. Looking first at the 1990 cycle, we notice that as measured by the severity of the drop below the horizontal axis, the recession was quite moderate compared to previous recessions, with a decline of only 1-to-2 percent. However it took fully 28 quarters or **seven full years** for the expansion to return economic growth to its pre-recession trend and so fully recover the growth lost during the recession. As we can see from the graph, the economy was expanding but due to the **absence of super-normal growth**, it was not growing fast enough to make up for the growth lost during the recession. Turning next to the 2001 recession cycle, we observe a similar pattern to 1990. Once again 2001 involved a very shallow recession followed by an extended period of below trend growth with real GDP growing **parallel to**, but **permanently below** the long-term trend. Importantly, after the end of the 2001 cycle which lasted 25 quarters, **the economy never fully recovered the growth lost from the recession**. As a result, the next cycle began from a level below potential representing a **permanent loss** of economic growth. Finally and most revealing, we look at the 2007 cycle. At down 5-percent, the severity of the recession was worse than any recession since the Great Depression but most importantly we can clearly see that **there has been no recovery whatsoever relative to the long-term trend**. In fact, the gap between the current expansion and potential economic growth is growing, strongly suggesting not only a **permanent loss of economic growth** but a **deteriorating condition**.

Figure 7

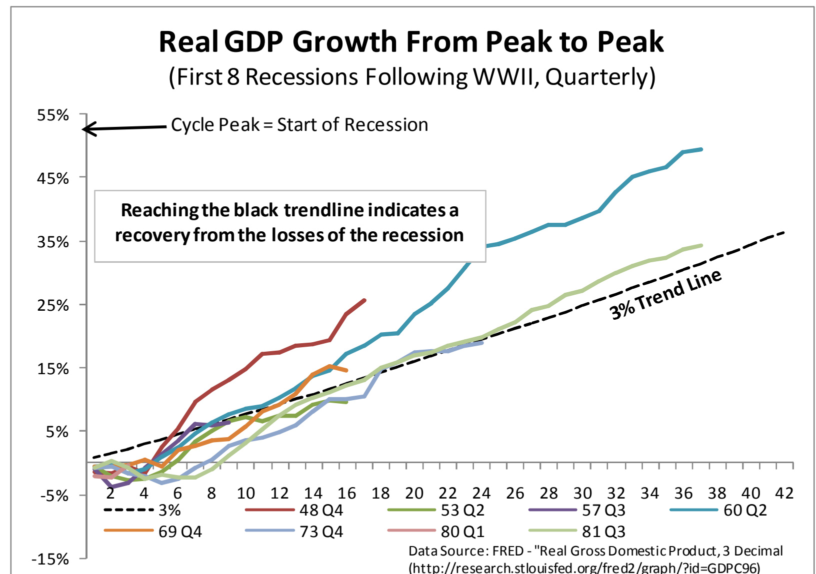
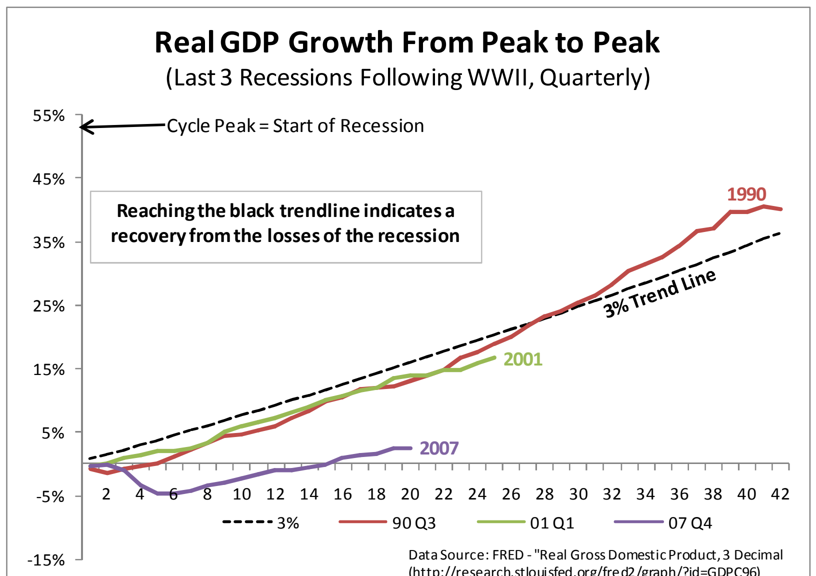


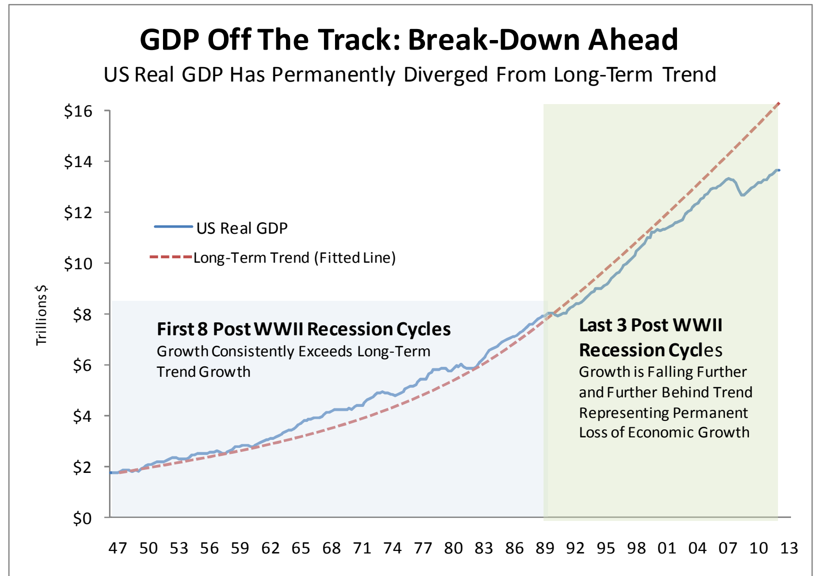
Figure 8



What is critical to understand from these two charts is that the pattern of the last three recession cycles has been markedly different from all other post-WWII recession cycles. In fact this coincides with our long-term contention that it is different this time; this time it is Austrian. As we have detailed previously, the recession cycle beginning in 1990 initiated the new pattern as this coincides with the launch of the infamous "Greenspan Put" and the beginning of the new era in central planning and market management replete with the institutionalization of moral hazard. Subsequent to Mr. Greenspan's installment as the new Chairman of the Federal Reserve, he underwent his baptism of fire with 'Black Monday' and the 1987 stock market crash. In the aftermath of that event, Chairman Greenspan

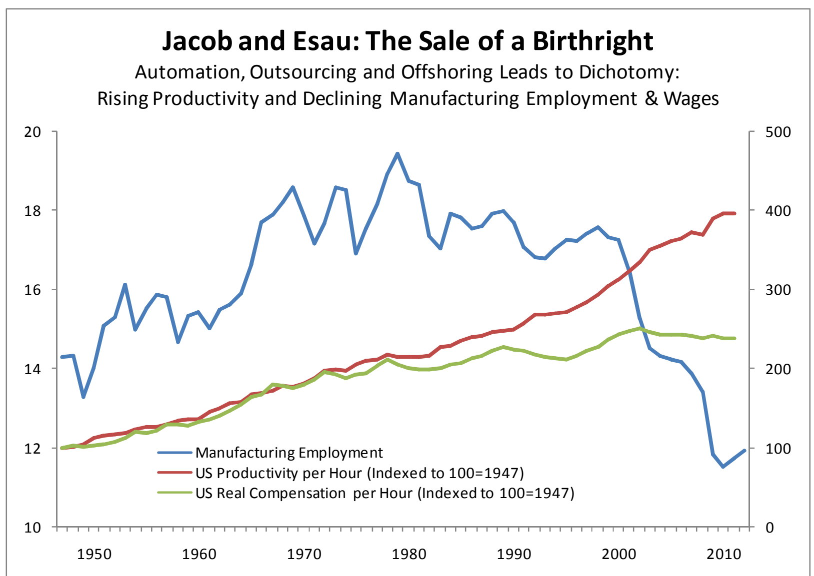
immediately lowered interest rates and pledged to provided excess liquidity in an attempt to avert a systemic crisis. From its ever so humble beginnings, the original commitment known as the Greenspan Put, has morphed into a mandate to intervene and interfere early and often and in ways heretofore never imagined, let alone authorized, in an effort to eliminate uncertainty and guarantee permanent prosperity. And it is this long-running new era of planning and manipulation which has resulted in the unprecedented expansion of non-productive debt, the destruction of wealth through the creation of massive malinvestments, and ultimately the permanent downshift in prospective economic growth. This impairment in economic growth can likewise be discerned from **Figure 9** which graphs US real GDP since WWII. Using the same demarcation as the two previous charts, we have highlighted the period encompassing the **first 8** and the **last 3** recessions with blue and green shaded areas respectively. We have also fitted a curve to the data which is representative of the curve-linear growth in real GDP across the period under review. As we can see, prior to the 1990 recession cycle, real GDP post-recession growth consistently exceeded the long-term trend growth line. However, beginning with the 1990 recession cycle, real GDP has veered off the track, falling further and further behind the prior long-term growth trend.

Figure 9



A key insight into this process of impoverishment driven by the perpetual intervention and monetary inflation of the stabilizers may been seen in **Figure 10**. Here we have graphed the historical trend in manufacturing employment against both productivity and real compensation per hour. Both productivity and real compensation per hour have been indexed to 100 with the start date of 1947. What is readily apparent is not just the well documented secular decline in manufacturing employment, but also the growing dichotomy between **rising productivity** and **falling compensation**. This particular constellation reflects our long running story of automation, outsourcing and off-shoring. Driven by perpetually low artificial interest rates and the evergreen emission of credit, the US has secured its' place as the consumer to the world while mercantilistic (and opportunistic) economies such as China, have gladly stepped into the role we vacated, that of manufacturer to the world. Not unlike the story of **'Jacob and Esau'**, the US, in 1971, abandoned the **'birthright'** which we secured subsequent to WWII under the Bretton Woods monetary agreement, when the US choose to renege on its pledge to maintain gold convertibility.

Figure 10



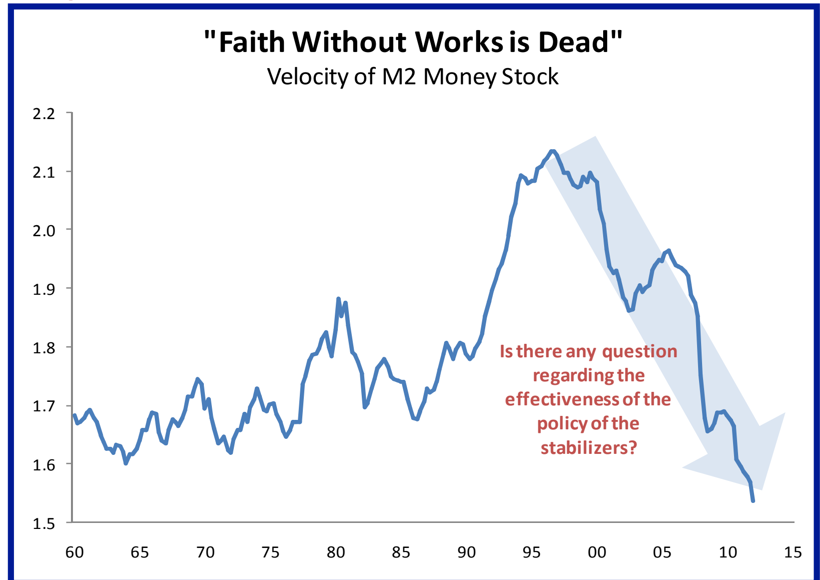
Subsequent to our repudiation, the world monetary system moved by default to a dollar standard, whereby other sovereigns were not only free but were, by force majeure, compelled to manage their respective currencies against an unanchored dollar. This established the basis for the ongoing **'faustian bargain'** which continues to influence today's terms of trade so that high paying manufacturing jobs are outsourced or off-shored in exchange for low-priced import goods, predominantly from Asia. We are immediately reminded of the story regarding the sale of Manhattan Island. Tradition holds that in 1626, Dutchman Peter Minuit purchased the island of Manhattan from Native Americans for "beads, bobbles and trinkets" totaling 60 Dutch guilders, or the equivalent of around US $24 at that time. As already amply illustrated, today's bargain, like that of the mythical Manhattan transaction, is a trade that just keeps on giving. Beads anyone?

It was the great coach John Wooden who reminds us; *"Never mistake activity for achievement."* We have long maintained that there has been no organic recovery since the onset of the Great Recession of 2007, only an increase in "activity" due to the massive amount of money and credit injected. This lack of achievement, chronicled in this report, by a government and a central bank who have clearly demonstrated by both word and deed, that they are, in the words of new Japanese Bank of Japan Governor Haruhiko Kuroda, willing to do *"whatever it takes"*, should leave no doubt in our readers mind as to our assessment of the probability that they will succeed in restoring organic growth which would necessitate raising short-term interest rates -- and so ***cause*** a secular rise in long-term interest rates. The most critical point to understand from our unintentional defense of bonds, is that the nature of the change, both in the degree of intervention by the stabilizers and the projected path of future economic growth -- **is permanent**. We have been making this case for years reminding our readers that ***this time it is different*** and ***this is no longer your daddy's bond market***. We have entered a period where intervention and monetary inflation will be permanent feature of the global economic and financial landscape. The US economy, and indeed the majority of the developed economies of the West, have, like Japan fallen into the irresistible gravitational pull of the black hole of debt deflation. As we have catalogued in the past, much of this is due directly to the culmination of the deleterious effects of the long-running policies of inflationism and interventionism in an effort to support the burgeoning growth of the nanny state. Not for the last time, let us repeat that in a world teetering on the edge of a deflationary abyss, and with money printing and monetary devaluation the only tools available to the Keynesian planners, **Atlas will not shrug** -- interest rates will not, nay, they cannot be allowed to rise sharply or the entire house of cards, built upon the quick sands of un-backed credit and money creation, will come crashing down. At this writing, the Federal Reserve currently owns over **30 percent** of all US Treasury debt when measured in 10-year duration equivalents. That is a staggering commitment, illustrative of the resolve of the stabilizers to keep long-term interest rates low. The structural fiscal deficit in the US is running in excess of **$1 trillion per year**, and absent any meaningful and politically painful restructuring of entitlements, these deficits can only grow in perpetuity. Against this backdrop, **quantitative easing** is the only thing standing in the gap, therefore, regardless of the jawboning and rhetoric by the stabilizers, it cannot be withdrawn. This opinion, as we have documented in the past, is shared by many others. Among them is the head of one of the largest and most respected bond management frims on the planet -- no not that one, the other one -- Jeffrey Gundlach of DoubleLine. In one of his recent presentations, Gundlach echoed our sentiments when he quipped; *"Those predicting a collapse for the bond market are 'dead wrong'. The message is that ZIRP and QE are a way of life now, find ways to cope and profit."*

Could there be other potential causes for a sharp rise in long-term interest rates? Certainly, among those might be the withdrawal of China from our Treasury auctions, another downgrade of US Treasury's, or the premature exit of the stabilizers. However each of these potential causes are effectively subordinated to greater question of the ultimate success of the stabilizers in avoiding the abyss of deflation and generating organic growth. Nevertheless, briefly, anyone who seriously believes that China will dump US Treasury's and so cause a spike in yields, clearly does not understand the dynamics of the **'faustian bargain'**. China has built an economy, not on a strong and growing middle class capable of consuming a significant portion of their own production, but rather on an export model geared to the largest consumer economy in the world. While China is clearly manipulating its currency for reasons of self-interest, a collapse of their export model would not only trigger economic pain, but prospects for social revolution. China must keep the millions who have migrated from from the farms gainfully employed in the

cities. Regarding another downgrade of US Treasury's, we need only suggest a review of the history of long-term treasury yields since the last downgrade on August 6th of 2011. From then until now, 10-year Treasury yields have rallied from 2.56 percent to 1.70 percent. So much for revulsion. In a world of increasing uncertainty, when the chips are down, we are still the best looking horse at the glue factory. In a phrase; *"To whom shall they go?"* Finally, with respect to a pre-mature exit by the stabilizers, as that has already been addressed in this review, we need only quote Mr. Gundlach again; "*There's a better chance Bernanke buys every Treasury bond in existence before he ever sells a single one."*

Figure 11



There is of course, one other possible cause for a sharp rise in long-term interest rates; hyperinflation. This has become the *cause célébre* of the Armageddon crowd. However, **Figure 11** which graphs the **velocity of money**, a proxy on the effectiveness of Fed policy to stimulate inflation, effectively sums up the probability of a hyperinflationary accident anytime soon. As we have previously stated, the stabilizers and their policies are the **efficient cause** of below market long-term interest rates. And also for reasons detailed here and in previous reviews, they will do ***"whatever it takes"***, fair or foul, to prevent a premature increase in long-term interest rates which would trigger a deflationary spiral. However, as Bastiat reminds us, it is prudent to guard against failing to consider the possibility of a hyperinflation, an extreme outcome of the stabilizers *providential intention* to generate inflation, due to a inviolable belief in the *absolute necessity* of the *efficient cause* acting to keep rates low. It is for this reason that we continue to recommend a strategic allocation to gold to preserve the **nominal purchasing power** of an investor's portfolio. For in this era of unstable stability, all assets are, to one degree or another, at risk from any number of random snowflakes (efficient causes) which could potentially trigger a deflationary avalanche. Nevertheless, some are better suited than others to weather such a storm. Bonds are legally enforceable contractual obligations to pay; stocks are not. Absent credit risk, every good bond goes to par and as such, the investor will have his capital returned, with at a minimum, a guaranteed income return. Stocks offer no such guarantee. Benjamin Graham, who along with David Dodd wrote the book on security analysis and value investing, held that the proper definition of an investment was; *"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."* In our opinion, given the era in which we are now living, high quality bonds are best able to meet that definition.

What then, of the declaration by the fear mongering 'rate-rising' crowd that long-term interest rates ***"surely will"*** rise? In the aforementioned article 'Fear Rising With Rates', the author makes the unequivocal statement; *"For many, if not most, it's a question of when the bond market sells off -- not if."* We are at once reminded of a true incident which happened several years ago involving a meteorologists' bold prediction regarding the probability that a tornado would form. After pre-empting all regular TV programming, the meteorologist made the following emphatic statement to a concerned and anxious viewership; *"Regarding the probability of a tornado in your area, it is not a question of if, it is only a question of when."* Fortunately for those in the affected area, within minutes the meteorologist quickly made his 'Emily Litella' mea culpa -- *"Never mind"* -- and promptly returned the station to its regular programming. With this in mind, we quote Voltaire for our answer to the 'rate-risers'; *"Doubt is not a pleasant condition, but certainty is absurd."*