Redstone Advisors



Economic and Market Review

Second Quarter 2013

"Then all the trees said to the bramble, 'You come reign over us.' And the bramble said to the Trees, 'If in truth you anoint me as king over you, then come and take shelter in my shade.'"

Judges 9:14-15

"The people that once bestowed commands, consulships, legions, and all else, now meddle no more and longs eagerly for just two things -- bread and circuses."

Juvenal, Roman satirist

With the markets engaged in the throes of a "taper-tantrum" and the economic *cognescenti* straining to interpret every Delphic utterance forthcoming from the Oracle of D.C., permit us to weigh in on the unfolding **"taper-caper."** In our opinion, the death of QE has been greatly exaggerated. Mark well our words, it is *"the death"* or total cessation of QE that we are eschewing. For as the Fed Chairman, armed with a clever and engaging automobile metaphor replete with both a gas pedal and a brake pedal has made so obscure, **tapering is not tightening**. And more to the point, tapering, once initiated, need not be sequential nor is it irrevocable. Ben has reserved the right to change his mind. In fact, he already has. After the *suggestion* by the Chairman of a potential time table for reducing monthly bond purchases (QE), interest rates summarily rose nearly 100 basis points. In the wake of the ensuing market conniption and sell-off, we have endured a cacophony of statements and speeches by various Federal Reserve sycophants who have attempted to "walk back the taper message." This frenzy of equivocating Fed-speak was capped with the *pièce de résistance* by the Chairman himself, who, while answering questions after a recent speech stated unequivocally that *"a highly accommodative policy is needed for the foreseeable future."* Emily Litella couldn't have said it any better. Confused? The Roman statesman Cicero once described this type of *illumination* as tantamount to *"carrying an unlit torch into a dark room."*

What will the Fed do? While we stand by our longstanding assertion that "Atlas cannot shrug", we do however, wish to clear as to what that statement entails. By it we do not mean to imply that the Fed can **never** reduce or discontinue QE. To the contrary, we are convinced that as elucidated by the auto metaphor, the stabilizers intend to try and "accelerate" or "decelerate" the level of monthly bond purchases dependent upon *"economic and financial developments"*, notwithstanding the warning of Paul-Louis de Méré, *"that the good Lord deliver us from the snares of the devil -- and the metaphor!"* No rather by it we mean that the stabilizers will continue to do "whatever it takes" to **protect the interests of the banking cartel**. Still one may reasonably wonder whether we may be witnessing the resolution of the classical paradox which posits the hypothetical question of what happens when an unstoppable force meets an immovable object. In our allegory, what has always been immovable are the economic laws of cause and effect, i.e., the outworking of the principle of sowing and reaping. This was eloquently stated in 1914 by Austrian economist Eugen von Böhm Bawerk; *"Just as natural phenomena are governed by immutable eternal laws, quite independent of human will and human laws, so in the sphere of economics, there exists certain laws against which the will of man, and even the powerful will of the state, remain impotent."* What then of the unstoppable force? What remains unstoppable, in our opinion, are the efforts of the central planners to do "whatever it takes" to forestall a debilitating debt deflation, the occurrence of which would result in the insolvency of the banking cartel. The key to predicting the likely outcome of this tectonic encounter lies in a sober assessment of the Fed's real mandate which has been succinctly articulated by former Hoover Institute Research Fellow Antony Sutton; *"The Federal Reserve System is a legal private monopoly of the money supply operated for the benefit of the few under the guise of protecting and promoting the public interest."* For a hint regarding the likely outcome of the paradox, we refer the reader to an ancient Persian Proverb: ***"When the cat and mouse agree, the grocer is ruined."***

(316)687-2143 jyeskie@redstoneadv.com

For those who may be unacquainted with the origin of the Federal Reserve and the collusive relationship between the 'cat and the mouse', it would seem appropriate, in this the centennial year of the birth of the **Creature from Jekyll Island**, that we pause to consider just what 100 years of unconstitutional control over the nations' money supply has wrought. Writing in 1809 in opposition to a proposed Bank Bill to establish a central bank, Thomas Jefferson predicted; *"If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks will deprive the people of all property until their children wake-up homeless on the continent their fathers conquered."* Alas for our nation, in dismissing the warning of Jefferson, we have unwittingly sought refuge in the shade of the bramble.

How came Jefferson's 'tree of liberty' to seek the shade among the brambles? It may come as a surprise for many to learn that the United States had its **first central bank** even before the Constitution was drafted. Due to an expectation that the province of Canada would join the rebel colonies, it was chartered in 1781 as the **Bank of North America**. The Bank was modeled after the powerful Bank of England and despite some restrictions, it operated as a de facto central bank. Its tenure, however, was brief. Riddled with fraud it fell into political disfavor and after operating for just one year, its charter was not renewed and in 1783 it became a purely commercial bank charted in the state of Pennsylvania. Ominously, in 1980 the First Pennsylvania Bank of Philadelphia, the "oldest in the nation", had to be bailed out by the government.

However, the resolve of the United States to abstain from the perils of central banking was short-lived. In 1790, then Secretary of the Treasury Alexander Hamilton submitted a proposal to Congress for the charter of a **second central bank** known as the **First Bank of the United States**. Hamilton's proposal for a new central bank was vehemently opposed by then Secretary of State Thomas Jefferson. Thus began a well documented and acrimonious political debate which would pit two of the most visible figures in the founding of the United States and preoccupy Congress for many years, and out of which would be borne, our nations' first two political parties. Jefferson's Democratic-Republican party and Hamilton's Federalists party.

JEFFERSON: "A private central bank issuing the public currency is a greater menace to the liberties of the people than a standing army." "We must not let our rulers load us with perpetual debt."

HAMILTON: "No society could succeed which did not unite the interest and credit of rich individuals with those of the state." "A national debt, if it is not excessive, will be to us a national blessing."

The pros and cons notwithstanding, Jefferson correctly indentified the crux of the debate. The Constitution did not grant to Congress the power to create a central bank, but rather such power was explicitly reserved to the states or to the people. In his rebuttal to Hamilton's proposal Jefferson said: *"To take a single step beyond the boundaries thus specially drawn around the powers of Congress is to take possession of a **boundless field of power**, no longer susceptible of any definition."* [Please note the allusion to 'boundless power' as it will come up again] Then as now, Jefferson's warnings went unheeded. Hamilton won the debate and in 1791, Congress granted a twenty-year charter to the First Bank of the United States.

Over the course of the next 50 years, the young nation would vacillate between the sound money principles of Jefferson and the elastic money of Hamilton. After the non-renewal of its' charter in 1811, the First Bank of the United States was resurrected five years later in 1816 as the **Second Bank of the United States**, representing yet a **third attempt** to establish a central bank in the United States. This led to another famous political showdown in 1832, this time between sound money President Andrew Jackson and the banking cartel led by Nicholas Biddle, president of the Second Bank of the United States. As Jackson's first term of office neared its end, Biddle asked Congress for an early renewal to its twenty-year charter, gambling that Jackson would not risk an open controversy in a reelection year. The gamble failed. The renewal bill passed but to Biddle's consternation, 'Old Hickory' unhesitatingly vetoed the bill to renew the Bank's charter. Jackson subsequently won reelection by a landslide and thereupon he immediately withdrew all federal deposits from the Biddle's Bank, placing them instead into private, regional banks in an effort to cripple the bank. Biddle upped the ante and countered by contracting credit and calling in loans in a calculated effort to trigger a national panic and recession. Biddle got his recession but his strategy ultimately backfired. He was summoned before Congress to explain his actions and in consequence, the nations' **third central bank** since its founding passed again out of existence, but not out of mind. Retired from public service and writing from Monticello in 1814, Jefferson presciently epitomized the unrelenting allure, not unlike that of the much sought after mythical El Dorado, that was the money monopoly. *"Shall we build an altar to the old paper money of the revolution, which ruined individuals but saved the republic, and burn on that all the bank charters present and future, and their notes with them? For these are to ruin both republic and individuals. This cannot be done. The Mania is too strong. It has seized by delusions and corruptions all the members of our governments, general, special, and individual."*

The hydra-headed monster had been dealt a grievous blow, but the pursuit of *El Dorado* was very much alive. Between the end of the Second Bank of the United States in 1936 and the Civil War, was a period of dislocation and chaos frequently mislabeled by historians as the era of **free banking**. Banking during this period, was anything but "free", as the hard money supporters attempted to regulate and reign in the banking cartel. The cartel, however, was ultimately successful in its efforts to circumvent restrictions on its ability to create money, culminating in the passage of the National Banking Act of 1863. The Act established a new system of nationally-chartered banks, the structure of which was similar to the Bank of the United States with the exception that instead of one central bank with power to influence the activities of others, there were now to be many national banks with control over all of them coming from Washington. Promoted as a wartime necessity to raise money for military expenses by creating a market for government bonds and then converting those bonds into circulating money, in retrospect, it established an unassailable foothold for the cartel **by making it impossible from that date forward for the federal government to ever get out of debt**. This fact was conceded by no less of a Keynesian apologist than John Galbraith who said: *"In numerous years following the* [Civil] *War the Federal government ran a heavy surplus. It could not pay off its debt, retire its securities, because to do so meant there would be no bonds to back the national bank notes.* ***To pay off the debt was to destroy the money supply****."* From this point forward, for good or for ill, the state and the banking cartel, like the cat and the mouse, were inexorably bound together.

Writing in his book 'The Creature from Jekyll Island' author G. Edward Griffin states; *"The period between the Civil War and the enactment of the Federal Reserve System was one of great economic volatility and no small measure of chaos. The National Banking Acts of 1863-65 established a system of federally chartered banks which were given significant privilege and power over the monetary system. . . . The net effect was that the banking system of the United States after the Civil War, far from being free and unregulated as some historians have claimed,* ***was literally a halfway house to central banking****."* Into this period of nascent industrialization, sprang a progressive notion; that of generating perpetual prosperity through the production of money. Smitten by this Midas-complex, the nation became mad with the alchemist desire to turn everything into money. Personal checks became accepted in commerce as readily as bank notes and personal lending, while still in its infancy, was to begin it's irrepressible rise. In his book 'Fifty Years of Managed Money: The Story of the Federal Reserve', author Elgin Groseclose observed: *"The manna of cheap money became the universal cry, and as with the Israelites, the easier the manna was acquired, the louder became the complaint, the less willing the people to struggle for it."*

The stage was set for the final assault and it would be *once more unto the breach.* It has been said that the basic ingredients of opportunity are few, but the one indispensable ingredient is **economic distress**. Altogether, America experienced four major contractions of the money supply leading to economic booms and busts during the period between the end of the Civil War and the establishment of the Federal Reserve in 1913. These periods of **"economic distress"** were the so-called panics of 1873, 1884, 1893, and 1907. Each episode was characterized by insufficient bank reserves followed by the suspension of specie payment. Central bank apologists have maintained the myth that the booms and busts that occurred during this period were the inevitable result of the greedy pursuits of *free and competitive banking*. In fact, these destructive "Pavlovian" cycles were designed to *prepare the way* for the full and final acceptance of a long awaited central bank. Each boom-bust cycle occurred as the direct result of the creation and subsequent extinguishment of fiat money through a system of federally chartered national banks, subsidized by the government, invested with monopolistic privileges and dominated by a handful of firms on Wall Street - in short, they occurred under *"a halfway house to central banking."* Owing to this *halfway* *house system*, the banks could now pursue a more radical and systematic inflation, but the system still fell short of the goal of **full cartelization of banking**--the promised riches of El Dorado--a **monopoly on money production**. Still lacking was a **"lender of last resort"** to protect the cartel from insolvency and transfer the inevitable losses from the cyclical busts to the taxpayer and the means to prevent a cartel member from defecting and competing against the cartel. While the lender of last resort would not be inaugurated until the establishment of a central bank, the solution to the second objective was offered by J.P. Morgan partner Henry P. Davidson, in testimony given before a Congressional committee in 1912; *"I would rather have regulation and control than free competition."* John D. Rockefeller was even more blunt; ***"Competition"*** he said, ***"is a sin."***

At last we are able to consider the events surrounding the actual creation of the Federal Reserve System in 1913. The true story of the birth of the 'Creature form Jekyll Island' is a story full of both intrigue and deception. Many would consider it a tale fit only for conspiracy mongers or those of the tin foil hat crowd, but never one fit for a serious exposition of political economy. While we vehemently deny affiliation with the former, we accept full responsibility for pursuit of the later. After all, what is the definition of a conspiracy? Answer: *A conspiracy is an explanatory proposition that accuses two or more people, or a group or an organization, of having caused or covered up, through deliberate collusion, an event or phenomenon of great social, political, or economic impact*. Ever heard of Watergate, Iran-Contra, Whitewater? Or perhaps you prefer more recent examples. How about Benghazi-gate, the IRS scandal or NSA's Prism? For the love of liberty, the CIA is by definition a conspiracy! All attempts to dismiss or ridicule to the contrary, the fact remains that not all conspiracies are the product of paranoids. *"Truth"* as Mark Twain once observed, *"is stranger than fiction, because fiction is obliged to stick to possibilities; Truth isn't."*

What is true is that on the night of November 22, 1910, a delegation of six of the nation's leading financiers departed in secret from the railway station at Hoboken, New Jersey, bound for a private resort island off the coast of Georgia owned by J.P. Morgan, known as **Jekyll Island**. Those six men were:

1. Rhode Island Senator Nelson Aldrich, Republican whip in the Senate, Chairman of the National Monetary Commission, business associate of J.P. Morgan and father-in-law to John D. Rockefeller, Jr.;
2. Abraham Piatt Andrew, Assistant Secretary to the US Treasury;
3. Frank A. Vanderlip, president of the National City Bank of New York;
4. Henry P. Davison, senior partner of J.P. Morgan Company;
5. Benjamin Strong, head of J.P. Morgan's Bankers Trust Company and the future first president of the New York Federal Reserve Bank;
6. Paul M. Warburg, partner in Kuhn, Loeb & Company, brother to Max Warburg, head of the Warburg banking consortium in Germany and the Netherlands, and future Federal Reserve Board member.

That six of the most powerful men in the world of finance, surreptitiously slipped out of town, retreated to a private location, to engage in a clandestine meeting, the purpose of which was to establish a new monetary order, the powers enumerated therein being in direct contravention to the Constitution, is not a matter of speculation, but one of historical fact. Writing in the February 9, 1935 issue of the Saturday Evening Post, Frank Vanderlip, one of the six, wrote;

> *"Despite my views about the value to society of greater publicity for the affairs of corporations, there was an occasion, near the close of 1910, when I was as secretive--indeed, as furtive--as any conspirator. . . I do not feel it is any exaggeration to speak of our secret expedition to Jekyll Island as the occasion of the actual conception of what eventually became the Federal Reserve System.*"

The full story of the actual political maneuverings and clandestine activities of high ranking officials, both elected and unelected, necessary to bring about the passage of the Federal Reserve Act of 1913, would, were it not for Twain's admonition regarding plausibility, make for a bestselling conspiracy novel. Unfortunately, the time required to do so here would be more than prohibitive. For those who feel inclined to *"follow the money"* more closely, we would heartily recommend either of the previously mentioned books by Griffin or Groseclose, or the book 'The Secrets of the Federal Reserve' by Eustace Mullins. Suffice it to say, as we bring this overlong tale to an end, on December 23, 1913, President Woodrow Wilson signed the Federal Reserve Act, inaugurating what Jefferson had originally characterized as an *"unconstitutional"* monopoly on money, and ending the long struggle waged against central banking in the United States.

What had been created? In the words of A. Barton Hepburn of Chase National Bank taken from a 1913 address to the America Bankers Association; *"The measure recognizes and adopts the principles of a **central bank**. Indeed, if it works out as the sponsors of the law hope, it will make all incorporated banks together joint owners of a **central dominating power**."* [Note again the reference to a dominating power] Hamilton could finally rest in peace. After more than 120 years of striving, the United States would have a *central bank* established to be a *central dominating power*. If that is not the definition of a cartel, then brambles cast no shade.

How was it received? The December 24, 1913 New York Times carried a front page headline; "WILSON SIGNS THE CURRENCY BILL!" Below it, also in capital letters, were two further headlines; "**PROSPERITY WILL BE FREE**" and "**WILL HELP EVERY CLASS**." What of the opinion of those dissenting? On the day of its passage, in the House of Representatives, the following words of Congressman Charles Augustus Lindbergh, Sr. were entered into the official Congressional record; *"This Act establishes the most gigantic trust on earth, When the President signs this bill, the invisible government by the **Monetary Power** will be legalized. The people may not know it immediately, but the day of reckoning is only a few years removed."* [There's that pesky 'power' word again]

How is it sustained? From a letter written in 1863 by the Rothschild brothers of London to their banking associates in New York we read; *"The few who understand the system will either be so interested in its profits or be so dependent upon its favors that there will be no opposition from that class, while on the other hand, the great body of people, mentally incapable of comprehending the tremendous advantage that capital derives from the system, will bear its burdens without complaint, and perhaps without even suspecting that the system is inimical to their interests."* Simply and cynically stated, with respect to your standing as regards the existence of a money monopoly, you are either complicit or complacent.

Why weary our readers with such a long and fanciful narrative? We began this Review by posing the question "What will the Fed do?" Coincident to this, we said that to answer this question aright, we must first understand the Fed's real mandate or as we noted in our last Review, in the words of Aristotle; *"We do not have knowledge of a thing until we have grasped its why, that is to say, its cause."* For those who may still labor under the illusion that the purpose or as Aristotle might say, the ***cause*** of the Federal Reserve System is to stabilize the economy and protect the public through the superintending of a stable currency and full employment, it is time to be disabused of such a notion once and for all. The story of the Federal Reserve System, as we have presented it, is not one of conspiracy, promoted by the *tin foil hat crowd*, but rather the story of history, that of the **pursuit of power**. In Bertrand de Jouvenel's masterful book, 'On Power', we read that *"the essence of power is command. Power is command that lives for its sake and for its fruits."* Jouvenel continues; *"Anyone wishing to regard the nation as a moral being, endowed with a collective conscience, and capable of exercising a general will, **must see in power** what Rousseau saw - another being, with its own conscience and its own will, drawn on by natural egoism to the pursuit of its private advantage **through the expansion of its power**."* But power, and in particular the power of the state to expand without limit, for good or for ill, requires a partner. And that partner is **money**.

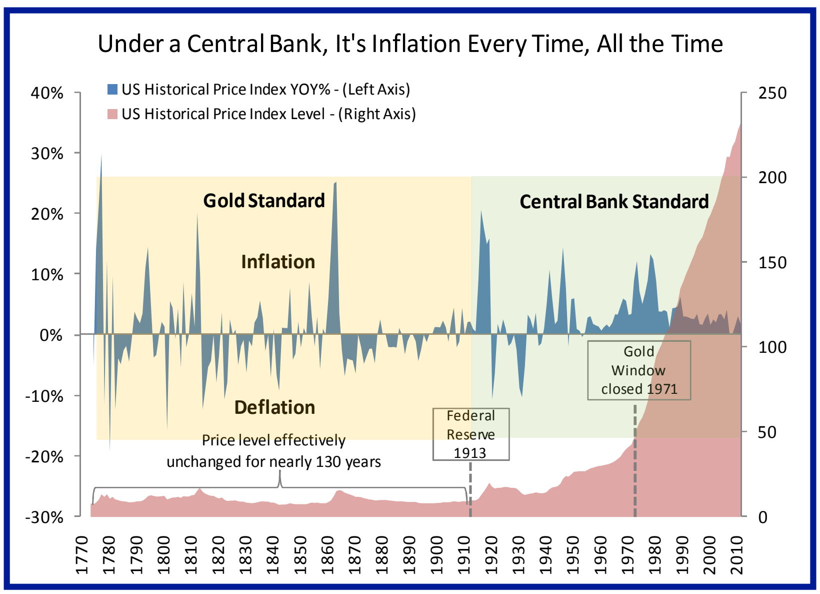
Why money? Money is unique. It serves a critical role in society. As the Preacher declares in Ecclesiastes 10:19; ***"money commands all things."*** For while it is labor that imputes value to all things, as the instrument of commerce, as the sole medium of exchange, it is money that equilibrates the exchange of all labor, and therefore it is money that commands labor, the progenitor of all wealth. As such, no one is immune, no one is exempted, no one is disinterested. According to the

United Future World Currency manifesto, a group whose goal is to unite the nations of the world under a single common currency; *"Money is the only invention capable of embodying both dreams and reality in an indissoluble bond; it is the abstract distributor of hope and a complete means of controlling the lives of human beings and nations."* As such, the invention of money was both a blessing and a curse. A blessing in that it enabled the attainment of equal opportunity and the "pursuit of happiness" through the specialization of labor which gave voice to the unique differences inherent in each individual, allowing everyone who chooses to apply themselves, an opportunity to go as far as their ability would take them. In short, honest money was the noble defender of liberty and individualism. A curse since by its' very role as handmaiden to the protection of liberty, if abused, it could be, as quoted above, the very "*means of controlling the lives of human beings and nations*", i.e., a means of enslavement. So just what has 100 years of unconstitutional control over the nations' money supply wrought? In brief, it has underwritten what the 19th century historian Jacob Burckhardt called *the "domestication of individuality by the vast increase in the power of the state over the individual."*

Individual liberties are increasingly restricted by increasing collectivism in two ways; positively through an increase in regulations, imposing restraints and compelling compliance, and negatively through an increase in taxation which diminishes the portion of individual profits which can be spent as the individual chooses. Not all regulation, however, is established to prevent injustice, some is established to protect it. Such is the nature of a monopoly where artificial barriers to entry and severe penalties for non-compliance, reduces or eliminates competition, thus securing the blessings of scarcity for the vital few. More importantly however, as we have discussed on many previous occasions, the most inequitable tax imposed by the state for the negation of liberty, is one that while insidious, is also nearly indiscernible--inflation. Returning again to our favorite quote from Lord Keynes, the father of modern inflationism; *"By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."*

How has liberty been annulled and the individual domesticated? Through an elastic money supply, through a lender of last resort, through inflation, in short, through a central bank. The purpose or mandate of which has been, and always will be, to provide, via inflation, an inexhaustible source of money for the expansion of the state and a perpetual source of profit to the cartel. Recall that properly defined, inflation is not an increase in a price index, rather inflation is an increase in the supply of money without a commensurate increase in real savings. However, while the price of individual commodities may rise and fall due to the impact of factors of supply and demand specific to those commodities, the price of all commodities cannot rise unless the value of the underlying denominator (money) has been decreased. As such, while a rise in the price index is not inflation per se, it is the **result** of inflation. Looking at **Figure 1**, we can see that for the nearly 130 years between the founding of the US and the establishment of the Federal Reserve, prices of all commodities, as reflected by the historical price index, were as likely to fall as rise. In fact during this time period, the nation experienced "inflation" 57 percent of the time and "deflation" 43 percent of the time. However, after the establishment of the Federal Reserve in 1913, prices have risen 90 percent of the time, and since the abandonment of the final

Figure 1



vestige of the gold standard with the closing of the gold window in 1971, it has been inflation **98 percent of the time!** If the purpose of a central bank was really to provide "stability" through an "elastic currency" then why under the auspices of a central bank, do we only get inflation? To any thinking individual, this is no accident. It is rather, the result of an intentional policy to inflate the money supply for the reasons already stated. That the ***raison d'être*** of a central bank is inflation, cannot be in doubt. The only matter that remains capable of question, is whether there are any just and equitable social benefits to be derived from the production of money?

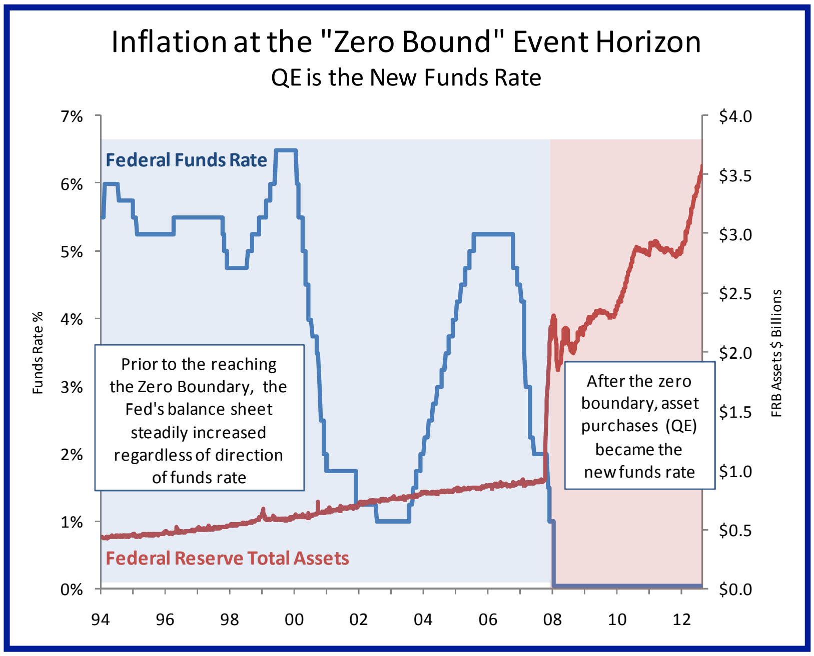
The production of money has an enormous impact on the relationships between people and societal groups. We have for years agitated against both the **injustice** as well as the **disutility** of the continuing policies of **intervention** and **inflation**, the results of which have been a massive *degree of disorder* in both the financial markets as well as the economy. Inflation, as previously defined by Keynes, is an instrument for promoting social injustice. It's insidious impact breeds irresponsibility, speculation, and an arbitrary and inequitable distribution of wealth and income. Writing in the second quarter of 2012, we addressed the impact of inflationism on society and said;

> *"The stabilizer-induced boom-bust-boom cycle, both* ***redistributes*** *and* ***destroys*** *wealth through the debauchment of the currency, but it does not do so evenly. The favored few who receive the new emission of credit first [the banking oligarchy] obtain a* ***"claim"*** *against existing wealth that did not arise from productive activity. As such they stand in a position to exercise their claim and so command or* ***"draw off"*** *existing wealth before any adjustment to the relative price structure can take place. However, those unfortunate enough to possess the new money at the moment of its depreciation will obtain a* ***smaller gratification*** *for the same amount and it is in this way that they are* ***impoverished****, almost imperceptibly, day by day. It is that* ***"loss"*** *that small, undetectable act of legalized theft which,* ***after forty years****, has swollen into a massive deprivation which today threatens many in the US and indeed throughout much of the socialized West, with a* ***famine of epic proportions****. Not a famine of grain, but a* ***famine of income*** *as reflected by the* ***stagnation of real incomes*** *and the ongoing* ***polarization of income*** *between the wealthy and the poor. A policy of inflationism and interventionism* ***is wrong****, and by extension* ***"we are doomed"****, not just because the policy doesn't work, but because it is* ***immoral****.*

We have on other occasions, addressed the impact of inflationism as it applies to investment and in particular, the stabilizer's claim of eliminating uncertainty by ensuring stability. Without contradiction the greatest chimera ever foisted on the minds of men by the "eternal state" is the sophistry of stability and security. We live in a world of perpetual change and uncertainty, and what is uncertain is by definition both unknowable and immeasurable. This is the essence of risk. When translated to investments; ***risk is always the permanent loss of capital, risk is never a number*** (volatility). Simply redefining risk as volatility does not alter that truth. Inflationism, like the rising tide that lifts all boats, has been the source of the stabilizer's "success" at reducing volatility, not risk, and basis of the illusion of increased stability. This occurs because credit has a paradoxical effect on stability. For although debt and leverage increase the level of systematic risk, the evergreen expansion provides the markets with the liquidity to re-flate underlying asset prices and so dampen adverse price movements or volatility. Minsky referred to this as "ponzi finance." However it was also Minsky who said **"stability begets instability"**, a warning that *"success"* at stabilization carries its own risks. After more than five years of emergency stimulus, the markets are awash with liquidity, but are a perfect picture of Minsky's **"stable instability"**, i.e., fragile. Due to the exponential growth in derivatives and their acute concentration in few hands within the cartel, should certain asset prices collapse too far or the expansion of credit be interrupted, the hazards currently submerged by this tide of liquidity would be revealed. As Warren Buffet once famously observed; *"It is only when the tide goes out that you learn who's been swimming naked."*

What then will the Fed do? Let's see, we understand their motive or mandate; we understand their method. Drum roll please . . . . they will inflate to a *fare-thee-well* because that is what they must do. Alright but will they increase, reduce or eliminate QE? Yes. But isn't that a contradiction? No. The difficulty arises due to the fact that the exception, that is QE, has been supplanted for the rule, which is perpetual inflation. In other words, **QE is the new funds rate**. In the past, people had been conditioned to think "tighten" when the stabilizers raised the funds rate and "easing" when they lowered the funds rate. Never mind the fact that total loans outstanding, excess reserves and prices, always and only increase. However a funny thing happened at the **zero-boundary**. (**Figure 2**) Not unlike an *event horizon*, the process of perpetual inflation via the **"mandrake mechanism"** of fractional reserve deposit pyramiding broke down when the loan market collapsed. The primary means of money production for the cartel has historically been through the expansion of loans by way of fractional reserve banking. In the wake of the Great Recession, however, loan demand collapsed as collateral (asset) prices plummeted and wealth claims (money) were destroyed. This contraction of money and credit due to the destruction of debt is properly called **deflation**. And despite all the *noise* in the financial markets, **it is the peril of a debilitating debt deflation that continues to threaten the cartel**. This is why the stabilizers must inflate.

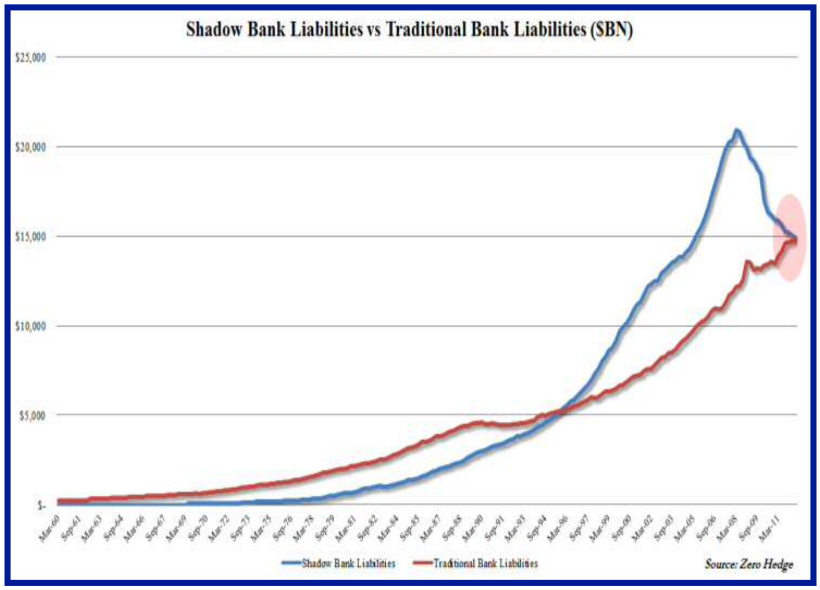
Figure 2



As we have been reminded in this Review, all money is debt, all money is loaned into existence. Amplifying this in a recent essay, James Sweeney of Credit Suisse said; *"Stated simply: the modern monetary system based on "promises to pay" only works as long as nobody actually demands payment, and especially not all at the same time which is what happened in 2008. It also explains why the only way to mask the fundamental insolvency of the modern monetary experiment, is to* ***keep creating money-equivalent credit at all times and costs.*** *Any stop to such "money creation" and the false idol of monetary voodoonomics falls."* (emphasis added) When, due to falling asset prices or concentration of counter-party risk in "weaker hands" or the occurrence of a "black swan" event, confidence in the "promises" wane and repayment is demanded, debt (money) is extinguished and a potentially devastating debt deflation a la Japan, becomes possible. And as the Japanese experience of a two-plus decade deflation reminds us, once we cross the "event horizon" into a debt deflation, the tools of the stabilizers are powerless to extract the system from the gravitational pull of the black hole of deflation.

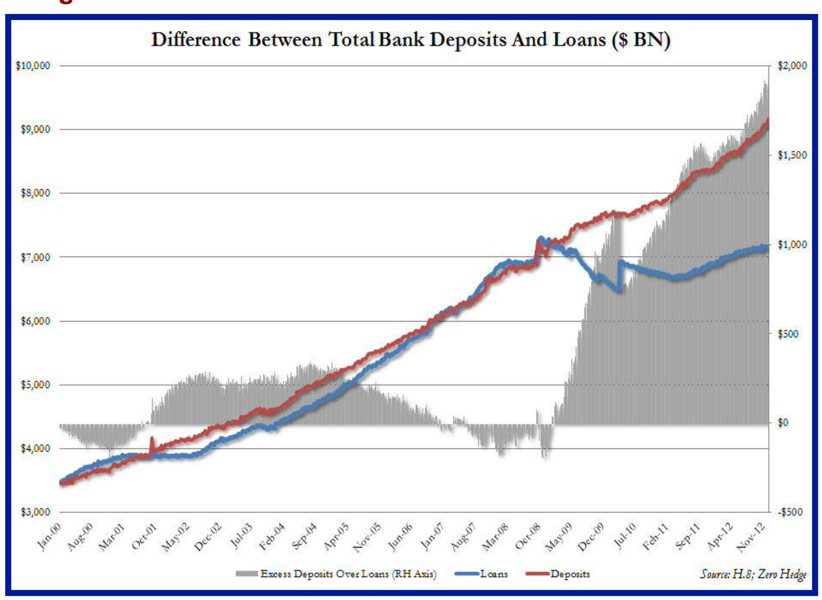
However, much of the growth in credit over the past several decades has been based on the pyramiding of **collateralized lending** or **securitization** through re-hypothecation or re-pledging of collateral. This introduces us to a *shadowy realm* known as the **"shadow banking system."** The shadow banking system is a real banking system and is, in fact, **at the very heart of the current crisis**. Shadow banking had its genesis in the 1980s and 1990s as an outcome of the deregulation of the banking and financial system, culminating with the repeal of the 1933 Glass-Steagall legislation which had kept commercial banking separate from investment banking. Out of this environment of deregulation came new banking product developments including repurchase agreements (Repos), money market mutual funds (MMMFs), special investment vehicles (SIVs), asset-backed commercial paper (ABCP), collateralized debt obligations (CDOs), “subprime” credit, and OTC derivatives, including credit default swaps. According to Yale economist Gary Gorton, this led to two important changes in the traditional banking system. According to Gorton those are; *"First derivative securities have grown exponentially in the last twenty-five years, and this has created an enormous demand for collateral. Second, there has been the movement of massive amounts of loans originated by banks into the capital market in the form of securitization."* Securitization involves the issuance of bonds that have came to be used extensively as **collateral** in repo transactions, freeing other assets, mostly Treasury bonds, for use as collateral for derivatives transactions. Promoted as a way to transfer credit risk to "stronger hands", securitization has instead acted to **concentrate risk** in the banking sector by allowing banks and other intermediaries to engage in a **"leveraged daisy chain"** by buying one another's securities, thus increasing the instability and fragility of the entire financial system (Hyman). It was in fact, the seizing up of the repo and commercial paper markets that provide the funding for the shadow banking system, that led to the collapse of the housing bubble and the ensuing financial crisis. The epic collapse in liability creation within the shadow banking system and hence the growing risk of deflation which activated the stabilizers to pursue such extraordinary monetary stimulus, is reflected in **Figure 3** courtesy of Zero Hedge. It was the Scottish poet Thomas Campbell, who in his poem 'Lochiel's Warning', idiomatically reminds us; ***"Coming events cast their shadows before."***

Figure 3



As noted previously, under a fiat monetary standard, money is loaned into existence, primarily through the process of loan creation in the traditional banking system or through securitization in the shadow system. Loans lead to deposits, which under a fractional reserve pyramid scheme, leads to more loans which begets even more deposits, *ad nauseam*. However, subsequent to the collapse of Lehman and the onset of the Great Recession and financial crisis, the traditional inflation channel, intermediation through the loan market, broke down. This can be clearly seen in **Figure 4**, again provided courtesy of Zero Hedge, where total bank loans (**blue line**) collapsed coincident with the initiation of the crisis. Yet bank deposits (**red line**), the representation of credit money in a fractional reserve banking system, continued to expand, with the difference between total bank deposits and loans (**gray area**) reaching approximately **$2 trillion**. This widening chasm of disintermediation between loans and deposits represents the **"invisible hand"** of the stabilizers, whose nearly $2.5 trillion in asset purchases under QE have resulted in nearly $2 trillion in excess reserves. This massive amount of money creation has not, to date, generated much visible consumer price inflation, in part because the official inflation measures are suspect, but primarily because the bulk of this new money has found its' way into **Wall Street** and not, as declining loan creation in **Figure 4** illustrates, into economic growth on **main street**.

Figure 4



Why then, if deflation remains the risk, would the stabilizers consider reducing or even eliminating QE? As all should understand by now, to protect the cartel. In the days before Lehman, money or deposit creation, was generated through either the loan or securitization channel. However post-Lehman, the stabilizers have been the primary source of money creation, with the bulk of this money creation ending up in the financial markets through the transformation of this massive deposit-to-loan gap into in risky activity through the labyrinth of hypothecation pathways within the shadow market. Inflationism via the shadow market is, as the **"London Whale"** scandal at JP Morgan reminds us, infinitely more hazardous as fiat money is both ubiquitous and fungible. Once in the market, the "money" becomes indistinguishable from money created in the loan market and as such, it respects no borders or restrictions. In truly democratic form, it is free to flow to the most profitable, and by definition, most risky leveraged carry trade available, whether in the US or Japanese stock market, or as hot money inflows to China's bubbling housing market. Therefore, in our opinion, for the stabilizers to consider reducing QE strongly suggests they are concerned, not about any potential harm the stimulus might have on the real economy, but rather the potential for another **"Lehman moment"** somewhere in the global markets, the occurrence of which, in the aftermath of the manifold trillions that has been created by global central planners, has the potential to bring down the house that Morgan built a century ago. In his book 'Currency Wars', economist and author Jim Rickards offers us an insightful avalanche analogy highlighting the problem currently faced by the stabilizers by drawing from the science of critical state dynamics in complex systems. *"The gradual part",* said Rickards, *"is a snowflake disturbing a small patch of snow, while the sudden part is the avalanche. The snowflake is random yet the avalanche is inevitable. Both ideas are easy to grasp. What is difficult to grasp is the critical state of the system in which the random event occurs."* Interestingly, this is precisely how Hemmingway described how one goes bankrupt; *"Gradually, then suddenly."* Stability, as an economic construct, is an empty notion, reflecting a "*heroic assumption that the unknowable can be known."* As such, we continue to hold that investment decisions should observe Pascal's law of uncertainty; **the severity of the potential consequences, not the probability of their occurrence, should inform the decision**.

For 100 years, the stabilizers have been back stopping the banking cartel and underwriting the expansion of the state which conveys the monopoly. As we have related in the past, the process of devaluing the monetary standard of the US has been a process, not an event. From its founding in 1913, to the demonetization of gold in 1933, to the establishment of a dollar standard in 1944, to the final abandonment of gold and the launch of a completely unfettered fiat monetary system with the closing of the gold window in 1971, the power of the partnership between the state and the money monopoly have grown immensely. If you doubt this, we invite you to consider several recent illustrations of the unbridled power of the state; in the martial law imposed on the city of Boston in the aftermath of the marathon bombing, in the revelation of the creation of a massive warehousing facility in Utah to be used by the NSA to collect surveillance data on every US citizen, or perhaps most revealing, in last year's Supreme Court ruling on the Affordable Care Amendment, i.e. "Obama Care", in which the state stretched credulity to the breaking point by defining the **non-activity** of private citizens as **activity** for purposes of **compelling activity** under the Commerce Clause. This, in the words of the dissenting justices, *" is to make mere breathing in and out the basis for federal prescription and to extend federal power to **virtually all human activity**."* (emphasis added) Under the guise of promoting stability and so promising to annul uncertainty, this, in short, is what a century of unconstitutional control over the nations' money supply has wrought; a manifestation of Hegel's proclamation of the **"state as God."** During the twilight of the Roman Empire, the Roman satirist Juvenal wrote scathingly about the people who once believed that a wholesome fear, borne of uncertainty, would be a fit guardian for Rome against the vice of unscrupulous ambition. Juvenal believed the Romans had lost the capacity to govern themselves, so distracted by mindless self-gratification had they become, and so in his '*Satires*' he wrote; *"The people that once bestowed commands, consulships, legions, and all else, now meddle no more and longs eagerly for just two things -- bread and circuses."* Unless we as a people, unshackle ourselves from the complacency that Rothschild so arrogantly predicted, and embrace again the truism that virtue is fortified by uncertainty just as surely as vice is emboldened by security, we too, may experience twilight in the empire as we shelter in the shade of statism.