



## Economic and Market Review

Second Quarter 2014

*"Consider the work of God; For who can make straight what He has made crooked? In the day of prosperity be joyful, but in the day of adversity consider: Surely God has appointed the one as well as the other, so that man can find out nothing that will come after him."*  
Ecclesiastes 7:13-14

*"Natural science does not render the future predictable. It makes it possible to foretell the results to be obtained by definite actions. But it leaves unpredictable two spheres: that of insufficiently known natural phenomena and that of human acts of choice. Our ignorance with regard to these two spheres taints all human action with uncertainty. The most that can be attained with regard to reality is probability."*  
Ludwig Von Mises, 'Human Action'

For centuries, theology was considered to be the "queen of the sciences", with all other branches of knowledge occupying places subservient to it, acting as it were, as its' handmaiden. However, subsequent to the *Age of Enlightenment*, an eighteenth century cultural movement in search of first principles led by such formidable names as Bacon, Voltaire, Hume and Kant, an era of rationalization and secularization was launched which in time, overthrew theology's age-old hegemony in the world of study. This great divide among the sciences culminated in the arrival of Nietzsche's theodanatology, or the "death of God." As a result, what was once ascribed to **Providence**, became the **province of probability**. Perhaps you will recall the final sentence of the Declaration of Independence; *"And for the support of this Declaration, with a firm reliance on the protection of divine Providence, we mutually pledge to each other our Lives, our Fortunes and our sacred Honor."* As an aside, we cannot help but wonder what we today, would be willing to venture on a mere probability?

Since that time, mankind has had to shoulder the mantle of omniscience in his struggle with uncertainty. Perhaps in no other endeavor of study has this been more clearly revealed than in political economy. Keynesianism, which so dominates economic thought today, grew out of the era of skepticism and positivism launched by the Enlightenment and embodied by men such as David Hume, John Stuart Mill and August Comte. Hume for his watershed criticism of the Law of Causality and Mill for his life-long advocacy of the application of the scientific method to political economy. Under the influence of such men, the study of political economy has been gradually subsumed into Comte's positivistic maxim: "Science is measurement." So much so, that today, contemporary economics concerns itself solely with that which can be measured. Such an approach clearly limits those "facts" which may be considered as possible causes in the real world. In *fact*, this limitation was delineated by Hume, whose axiom subjects all *a priori* reasoning to his litmus test of empiricism and, thereupon finding it lacking, declares; *"commit it then to the flames, for it can contain nothing but sophistry and illusion."* Having since capitulated to what physicist-turned-portfolio manager Mark Mueller calls "physics envy" - the desire to explain 99 percent of economic phenomenon with three laws - the practice of modern economics has sold out to the scientific method, culminating in the "mathematization" of economics. In light of this, one may reasonably ask why Newton could explain the motion of the planets with three simple laws while the application of scientific principles to economics has yielded only spectacular failure, with crises increasing in both frequency and severity? Perhaps the answer was suggested by the most imminent scientist of the twentieth century, Albert Einstein, when he observed; *"Not everything that counts can be counted, and not everything that can be counted counts."*

At its core, quantitative or the "**new economics**", is based on the belief that it is possible to build a formal mathematical framework for economic analysis that would be as predictive as those in physics. Yet positivism insists that only information derived from logical and mathematical treatments and from sensory perception may be called knowledge, and as such, intuitive or *a priori* knowledge is rejected. It was Comte who argued that, much as the physical world operates according to gravity and other absolute laws, so also does society. However, as our opening quote from Austrian economist Ludwig von Mises suggests, "natural science does not render the future predictable", but rather can at best lead only to what another Nobel-winning Austrian economist, Friedrich Hayek called mere "pattern predictions." Why is this so? Two words: human choice.

As we have oft repeated, economics is the "science" of human choice and as such, seeks to understand purposeful human action. People are unique in that they are volitional, sentient beings that consciously act, they evaluate their situation and make willful choices in order to purposefully interfere with, and alter their environment. In short, they are motivated by self-interest and exercise free will. Placed in the same or similar situation, two people may value and act differently, and the same person may value and act differently at different times. The problem comes down to what Dr. Warren Weaver identified in a 1948 paper entitled 'Science and Complexity' as the difference between "*disorganized*" versus "*organized complexity*." The essence of the difference was eloquently expressed by Shakespeare in Julius Caesar; "*The fault, dear Brutus, is not in our stars, but in ourselves, that we are underlings.*"

Physical scientists have developed powerful techniques in probability theory and statistical mechanics to deal with the problems of disorganized complexity that they encounter in the physical world. Dr. Warren defines disorganized complexity thus; "*It is a problem in which the number of variables is very large, in which each of the many variables has a behavior which is individually erratic, or perhaps totally unknown. However, in spite of this helter-skelter behavior of all the individual variables, the system as a whole possesses certain orderly and analyzable average properties.*" Contrast that with the problems of **organized complexity** which has to be dealt with when considering *underlings*. Organized complexity requires dealing simultaneously with a large number of variables which are **interrelated into an organic whole**. As such, economics deals with problems where the structure depends not only on the properties of the individual variables, all of which can never be fully known or measured, but must also deal with the synergism with which the individual variables interrelate with each other. In essence, the problem of trying to quantify human choice is analogous to Professor Michael Behe's concept of irreducible complexity. Irreducible complexity is a term used to describe a characteristic of certain complex systems whereby they need all of their individual component parts *in place* in order to function. It is impossible to simplify or reduce the complexity of an irreducibly complex system by removing any of its component parts and still maintain its organized functionality. In like manner, because we cannot identify, let alone measure, all of the interrelated variables which come into play with respect to human action, we, by non-inclusion of those variables, effectively "reduce the complexity" of an irreducible complex structure, rendering the predictive capability of the model invalid. Returning to Mises; "*The economic future, like the political future, will be determined by future human behavior and decisions. This is why it is **uncertain**. As such, whether one uses a ruler to extend an economic trend into the future, or a sophisticated econometric model with dozens of equations, the problem is still the same: **there are no constant relations in human affairs**. And as there are no constant relations between any factors, **there is consequently no measurement and no quantification possible.**" Theoretical physicist and Nobel prize winner Richard Feynman succinctly captured the unspannable gulf between predicting behavior in the physical versus the social sciences; "*Imagine how much harder physics would be if electrons had feelings?*"*

Despite the impracticability of the task, the stabilizers remain undaunted, pursuing their goal of central planning and economic fine-tuning with a Sisyphean-like labor. Laboring under the admonition, "*guess often, and may the law of probability be always in your favor*", the increasing mathematization of economics has played a key role in legitimizing **central planning** by an omnipotent state. Abba Lerner, a Russian-born British economist and Keynesian acolyte and forebearer of the "new economists", helped to develop the doctrine of "functional finance", which holds that the overriding purpose of the federal budget is to regulate the rate of total spending in the economy in the interest of economic stabilization. Another of the new breed of economists was James Tobin, a Noble prize winner who served as a member of John F. Kennedy's Council of Economic Advisors, the Board of Governors of the Federal Reserve System, and taught at Harvard and Yale Universities. He developed the ideas of Keynesian economics, and advocated government intervention to stabilize output and avoid recessions. In our opinion, one particular quote by Mr. Tobin candidly expresses both the disdain of the *new economists* toward a market economy and their overwhelming preference for central planning: "*Can we as a nation, by political decision and governmental action, increase our rate of growth? Or must the rate of growth be regarded fatalistically, the result of uncoordinated decisions and habits of millions of consumers, businessmen and governments, uncontrollable in our kind of society except by exhortation and prayer?*"

It has been, and remains, our contention that the *uncoordinated and uncontrollable decisions and habits of millions of consumers, businessmen and governments*, in other words the free-market economy, is not simply the best system among a panoply of options, but is rather, the only system that creates real wealth and improves social conditions. "*No one*," observed Austrian economist Murray Rothbard "*has perfect foresight into the uncertain future. But free entrepreneurs on the market are better equipped than anyone else, by incentive and by economic calculation, to foresee and satisfy the needs of the consumers.*" Central planners try to overcome uncertainty by substituting formulas for entrepreneurial judgment. They believe that they can replace the price system with commands, but they miss the whole purpose of individual action on the free market. Specifically that people, **faced with uncertainty** and driven by self-interest, pursue intentional, purposeful activity to provide for the events of an **uncertain future**. The choices of the *inconvenient individual* are fraught with irreducible complexity and as such, simply cannot be evaluated quantitatively, no matter how sophisticated the algorithm or model. Herein lies the great blind spot of all scientific economics, what Hayek referred to as the "**pretence of knowledge**." The illusion that we can accurately describe and predict this phenomena of *organized complexity* which is human action, through the expedient use mathematical models. In fact the theory that has been guiding the policy of monetary inflation for the past **40-plus years** consists in the assertion that there is a simple positive statistical correlation between total employment and aggregate demand. Such a belief leads inexorably to the fallacy promoted by the *new economists* that we can permanently assure full employment by printing money to maintain some optimal level of demand. By focusing solely on what could be counted, and disregarding what could not, we have pursued a **40-plus year** policy of increasing central planning and inflationism. While the future remains uncertain, we can be sure of one thing: Government interventions, based on some economist's modeling, will make matters worse. To paraphrase the philosopher-puppet Yoda; "*Now matters are worse.*"

The current economic malaise facing both the US and most western developed economies, which we have characterized as a **rolling** or **permanent recession** consisting of persistent below-potential economic growth, intractable unemployment, exponential growth in unproductive debt, chronic sovereign deficits, and a massive famine of income, is **structural** not cyclical. It is not the result of a *Fourth Turning*, an *Elliott Wave* nor a *Kondratiev Cycle*. Rather it represents the distortive impact of the culmination of over **forty years** of increasing intervention,

central planning and monetary inflation. During this period, the US economy has been transformed from a market economy to a mixed economy. And while a mixed economy does create wealth, it does so, not by virtue of autonomously rewarding individual achievement, but through a system of privilege and restraint, under which the *planners* pick "winners", and by non-selection, "losers", thus conferring an unjust advantage on one party over another. The result of which is an economy whose wealth creation is limited and whose wealth distribution is skewed in favor of the *vital few* over the *trivial many* (Pareto). However the forced transfer of wealth will always result in the loss of a portion of the wealth in the transfer. "*Owing to the Law of Providence [not probability],*" says Bastiat, "*a moment comes when the destruction of wealth is such, that the despoiler is poorer than he would have been if he had remained honest.*"

Whether you ascribe to Providence or probability, that "*moment*", so long in the making, has arrived. Let us be clear, neither we nor Bastiat are referring to a discrete event such as a recession or depression. No, rather as we have long maintained, this "*moment*" which has arrived is the culmination of a *process* long in the making, the cause of which was described by Ludwig von Mises; "*And then, very late indeed, even simple people will discover that Keynes did not teach us how to perform the miracle of turning a stone into bread, but the not all miraculous procedure of eating the seed corn.*" As we wrote last time, we have for years, agitated for a "small present evil", such as the severe but short-lived depression like the one America had in 1921, over what we have styled a "great evil to come" such as Japan's two-decades-and-counting Great Stagnation. We have long insisted that corrections - mild, modest, or severe - serve the useful purpose of clearing away the malinvestment of the credit-induced boom and restoring right relationships among the distorted factors of production if prices are allowed to adjust to market-clearing levels. Instead, time and again in the ensuing **40-plus years** of monetary manipulation since the abandonment of honest money in 1971, we have chosen the easy political option of postponement by "*eating the seed corn.*" This long-term process of deferral has culminated in this "*moment*" of an intractable decline in the ***national corn crib***, the result of which has been a permanent change in the way the world works. To quote the incomparable Yogi Berra; "*The future ain't what it used to be.*"

Yet based solely upon mainstream conjecture, one might be tempted to believe that asset bubbles, as unstable and potentially devastating as their collapse might be, are the only debilitating impact of a policy of perpetual inflation and intervention. However, to paraphrase Bastiat, this is only *that which is seen*. On the contrary, the most destructive impact of a long-running policy of inflationism - a slow, inexorable decline in economic growth and income production - like the death of a thousand cuts, is *that which is unseen*. This nearly imperceptible deterioration was aptly described by investment strategist Jeremy Grantham of GMO who wrote; "*Critically, the tech boom and bust and the following housing boom and housing and financial busts helped camouflage the recent unpleasant economic development lying below the surface: the steady and important drop in long-term US growth.*" As we are so fond of repeating, it was Keynes, the father of modern-day inflationism and interventionism, who ironically observed that the debauchment of the currency via inflation is a "*process which engages all the hidden forces of economic law on the side of destruction, and it does it in a manner which not one man in a million is able to diagnose.*"

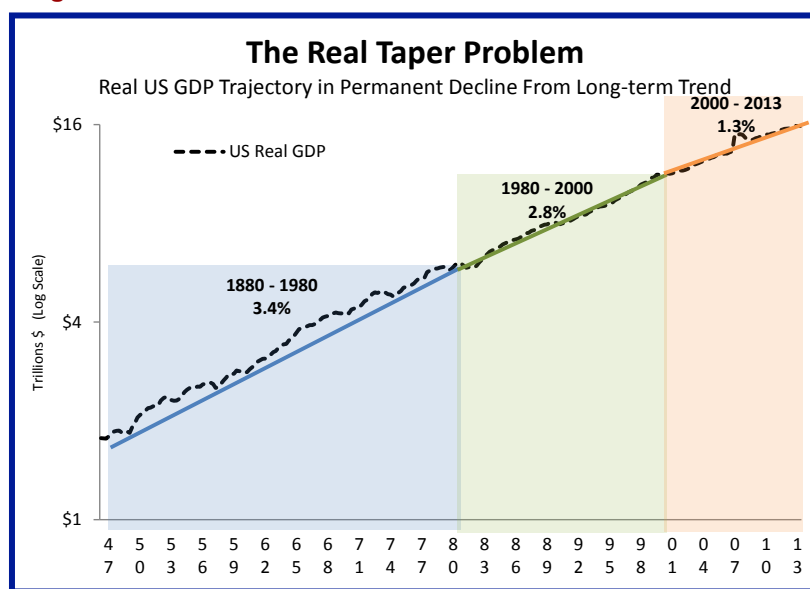
While clearly, ours has been a "minority report", we have not been alone in the *diagnosis* of this hidden and insidious process. Rather we have presented a compelling body of serious scholarship in support of the proposition of a paradigm of decline in US economic growth. On several occasions, the most recent being last quarter, we have considered the work of Dr. Edward Leamer of UCLA Anderson Forecast, Dr. Dimitri Papadimitriou of the Levy

Economics Institute and Dr. Robert Gordon of Northwestern University. In each case, research studies undertaken by independent authors with differing worldviews, have advanced the probability of a permanent downshift in potential future economic growth in the US, based on the continuation of **trends which have been in place for over 40 years**. Writing in late 2012, Jeremy Grantham perfectly parroted our long-running contention by asserting "*a declining growth trend is inevitable and permanent. . . . Times have changed.*"

Times have indeed changed. While the consensus remains focused on the current taper of the \$85 billion per month in asset purchases by the stabilizers, they remain oblivious to the **real taper problem**, the prospect of an *inevitable and permanent* decline in economic growth. The consensus remains convinced that with time and the expedient application of monetary largesse, we will return to our historical growth path. We strongly disagree. In our opinion, those days are gone forever. Referring to **Figure 1**, we can see that after expanding for **one hundred years** at a rate of **3.4% per year**, the annual rate of growth in US real GDP has entered a period of **marked and sustained decline**. Between 1980 and 2000, the annual growth rate of US real GDP fell to around **2.8% per year**, a decline of **18 percent per annum** versus the long-term growth rate of 3.4%. More disturbing still, since 2000, the annual growth rate of real GDP in the US has collapsed to only **1.3% per year**, representing a decline of **54 percent** from the 1980 to 2000 growth rate of 2.8% and a colossal **62 percent decline** from the 100-year growth rate of 3.4%. As we have discussed previously, the work by Dr. Edward Leamer focused specifically on identifying the **marked secular downshift** which has taken place in the recovery pattern of the three most recent recessions - 1990, 2001 and 2007 - as compared to all of the previous post-WWII recessions. Excepting only the 1990 recession, real US economic growth has failed to return to its pre-recession growth level, it took **seven full years** to achieve it, nearly **three-times** the average recovery period of all

other post-WWII recessions. However, subsequent to the 2001 recession, the economy **never** recovered the growth lost during the recession. As a result, the next expansion cycle began from a level **below the prior cycle**, representing a **permanent loss** of economic growth. Ditto for the 2007 Great recession, which, at down 5 percent, was the worst recession since the Great Depression. Nevertheless, despite the best "*whatever it takes*" efforts by the stabilizers, in the *recovery* that has ensued from the 2007 recession, statistical growth has been evident everywhere **except in the real economy**. There has been no organic growth, period! This type of "*success*", observed Winston Churchill, "*consists in going from failure to failure without loss of enthusiasm.*" After **40-plus years** of such success, our response to the rhetorical question posed earlier by Mr. Tobin, arrogating the supremacy of "*governmental action*" over the "*uncoordinated decisions and habits of millions of consumers*" in order to "*increase our rate of growth*", must be to demur. Perhaps it is time to pursue Mr. Tobin's much deprecated fall-back course of action, "*exhortation and prayer.*"

Figure 1

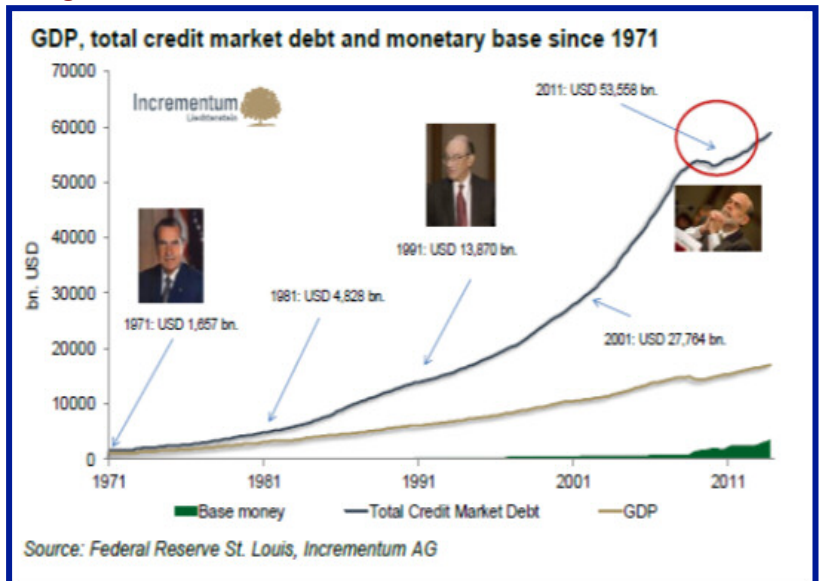


That the trend in economic growth has been, and remains, in a permanent and intractable decline, is, in our opinion, indisputable. That this trend and its implications is widely understood, is not. Over the course of the past few years, we have discussed in great detail, those reasons behind the decline. For simplification, we may reduce those reasons or "**headwinds**" to four; demographics, globalization, debt, and inequality. In our worldview, with the exception of demographics, all of these "headwinds" are the direct byproduct of the long-term trend in central

planning and inflationism, both made possible by the acceptance of scientific economics. Of those headwinds, a massive overhang of unproductive debt is perhaps the most readily discernible byproduct of the stabilizers long-running program of interventionism. Referring to **Figure 2**, a reproduction of a chart prepared by Incrementum AG, we can see that the closing of the gold window in 1971 by President Nixon, signaled the end of the **era of honest money** and the inauguration of the **era of planned paper money**. With that **tectonic shift** in monetary policy, economic activity, once directed by the market, based on the accumulation of real savings and real investment, was replaced by a mania in credit-induced growth increasingly controlled by the policies of the stabilizers. What is most striking is the marked **paradigm shift** in the relationship between credit and economic growth. Since 1971, total credit market debt in the US has risen **35-fold**, while GDP has risen only **14-fold**. Under today's debt-based monetary system, credit-induced growth is primarily "**created ex nihilo**" [an act previously ascribed by theologians only to God], by injecting additional credit money into the economy through an increase in lending or by an increase in government debt. Today, the continuing **chimera of stability** in the financial markets, depends almost entirely upon the continuation of this "evergreen" monetary inflation. Speaking out against governmental planning during the Presidency of Andrew Jackson [the last hard-money President], American journalist William Leggett presciently observed; "*In the complete separation of government from the bank and credit system consists the chief hope of renovating our prosperity, and restoring to the people, those equal rights which have so long been exposed to the grossest violations. Leave credit to its own laws.*"

By ignoring Leggett's caution, we have exposed ourselves to another important law, namely that "**inflation creates its' own deflation.**" Our '**fatal conceit**', aided by the abandonment of Providence for probability, has been to equate debt with money and therefore the production of debt with the production of wealth. This exchange was poignantly described by Garet Garrett in his book 'The Bubble that Broke the World; "*The Lord giveth increase, but man devised credit.*" Unfortunately, the sole precondition for a debilitating deflation under a fiat-based paper monetary system, is a massive build-up of unproductive debt. And because under our current monetary system, all money is debt, and all debt is somebody's asset (many times over through hypothecation and derivatives), the extinguishment of a debt instrument that has been monetized (turned into an asset), absent the incurrence and monetization of a new debt to offset it, risks initiating a self-reinforcing deflationary contraction, threatening the stabilizers with economic Armageddon. That the only policy option open to the stabilizers to forestall such an outcome

**Figure 2**

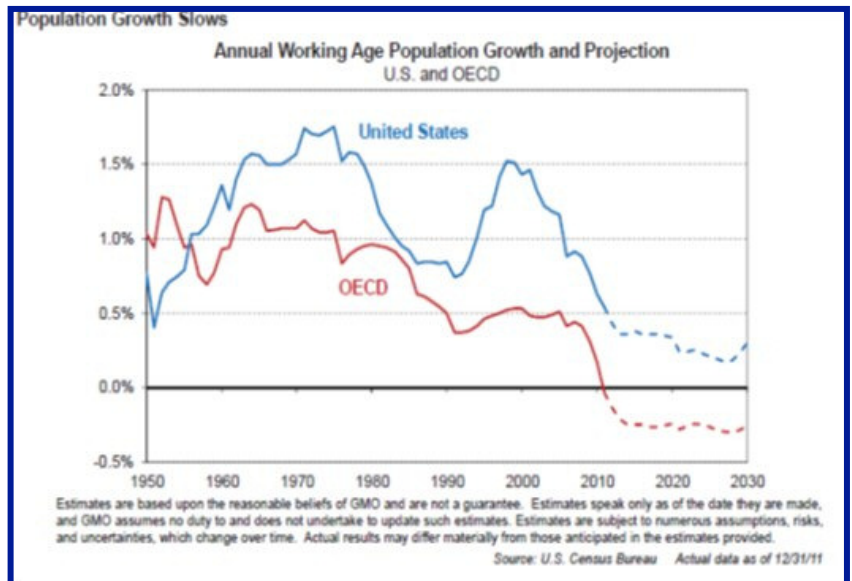


has been to "kick the can down the road" by supplanting an impotent or reluctant banking cartel in the creation of credit, has been the basis of our contention that *Atlas will not shrug*. Having finally reached the zero-boundary in their fight against deflation, central planners of all stripes are printing money, buying assets and manipulating markets for just one reason: they are paralyzed by the fear of what might happen if they don't - a debilitating debt deflation. And the stabilizers know that to follow Japan and enter upon that road, like the mythical entrance to Dante's Hell, is to "abandon all hope, ye who enter here." For a deflationary collapse of a global fiat monetary system is the astronomical equivalent of a black hole - upon entering, nothing can escape its gravitational pull toward collapse. For this reason it has been and remains our contention that the stabilizers will continue to do "whatever it takes", fair or foul, to avoid the abyss. From a zero interest rate policy, to a negative interest rate policy. From quantitative easing to "exit fee gates" on bond funds. From Bail-Outs to Bail-Ins. All options are on the table. Stating the case for the planners, it was former Secretary of State Henry Kissinger who, upon being told a particular action by the government was *illegal*, responded: "The illegal we do immediately; the unconstitutional takes a little longer."

**Demographics** refers specifically to those secular factors now conspiring to shrink the work force (Figure 3), reducing hours worked and ultimately economic output. Key among those factors is the coming retirement of baby-boomers and declining birth rates now below replacement levels as immigration slows and we increasingly become a nation of singles. It would appear that in the words of Charles Hugh-smith of OfTwoMinds blog, "the debt serfs simply refuse to be born", defying, apparently, even the best efforts of the stabilizers. And while these trends are slow moving forces, ultimately, if **demographics is destiny**, then decline is irrevocably baked into our future.

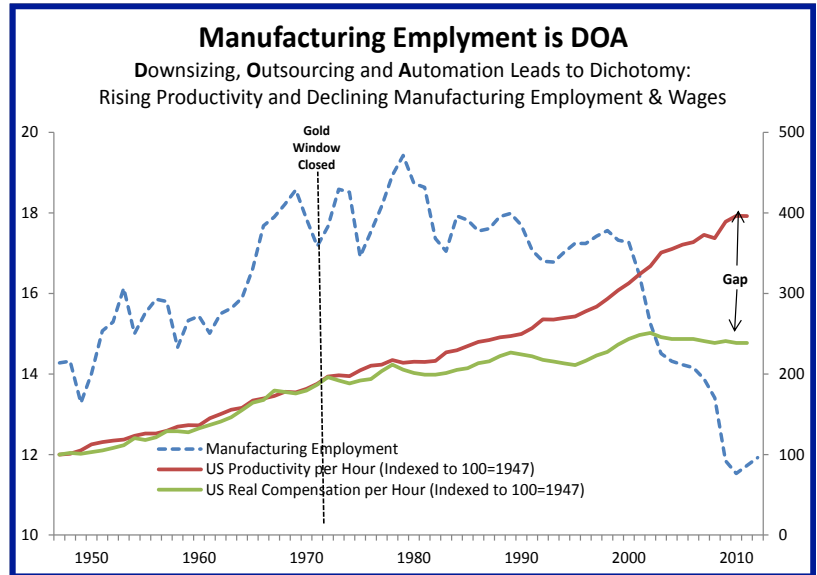
**Globalization** captures what we have referred to as the deleterious impact of **downsizing, outsourcing and automation (DOA)** on employment in the US, an "unintended" consequence of our **Faustian bargain** with low-wage developing nations. Figure 4 highlights the growing divide or "gap" between US productivity per hour and real compensation per hour. After rising in near lock-step with measured productivity for the period between the end of WWII and the early 1970s, productivity and real compensation per hour have parted company and manufacturing employment began its well documented decline. Driven by perpetually low artificial interest rates, the evergreen emission of credit and financial deregulation, there has been a massive global overinvestment in productive capacity, first domestically then increasingly directed to emerging countries where labor rates were dramatically cheaper and regulatory burdens were greatly diminished. As a result, productivity has soared while high-paying manufacturing jobs, and the wage incomes that attend them, have been pronounced DOA. Against this backdrop, 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

Figure 3



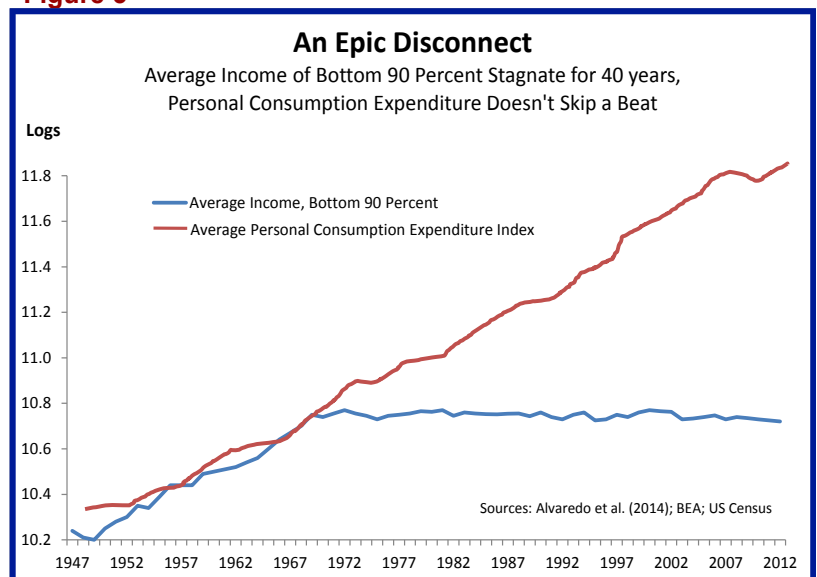
the story of 'Jacob and Esau', the US, in 1971, abandoned the 'birthright' which we secured subsequent to WWII under the Bretton Woods monetary agreement, when the US reneged on its pledge to maintain gold convertibility. Subsequently, the world monetary system moved by default to a dollar standard, 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. Clearly our leadership has driven a hard bargain. We give them our jobs and they give us "always low prices."

Figure 4



**Income inequality**, or what we have styled the "**famine of income**", is, in our opinion, the most important and perhaps least appreciated headwind resulting from stabilizers long-term policy of inflationism. However, the discoordinating influence of inflation on income becomes glaringly apparent, when, as in **Figure 5**, we isolate the change in real income between the top 10 percent and the remaining 90 percent. This underscores our contention regarding the existence of an **famine of income** as the growth in real income for the "trivial many" - the bottom 90 percent -- has been stagnant for **forty-plus years**, and has in fact been declining since 1999. Keynes himself conceded that "by a continuing process of inflation", governments **confiscate** the wealth of their citizens, "**impoverishing many,**" and "**enriching some.**" We have written extensively regarding the nature of the injustice due to the uneven redistribution of wealth and the polarization of incomes that results from the stabilizer-induced **boom-bust-boom cycles**. It is through these hidden, yet insidious processes that the "**vital some**" are enriched and the "**trivial many**" are impoverished almost imperceptibly, day by day. It is that loss, that small, undetectable act of **legalized theft called inflationism** which, after forty years, has swollen into a massive deprivation which today threatens many in the US and throughout the West with what we have described as a famine of epic proportions – a **famine of income** – that is pulling the US economy into the morass of a long, slow decline.

Figure 5





Recently we were introduced to economist' Robert Higgs concept of "**regime uncertainty**" in a research paper of the same name, written in 1997 to offer an alternate understanding of the Great Depression and the **extended duration of the non-recovery**. In his paper, Higgs argues that the economy remained in the depression as late as 1940 because **private capital investment** had never recovered sufficiently after its collapse during the Great Contraction phase (1929 - 1933) of the Great Depression. Higgs further argues that the **insufficiency of private investment** from 1935 through 1940 reflected a **pervasive uncertainty among investors** about the security of their property rights in their capital and its prospective returns. Writing in 1937, one of America's leading investors, Lamot du Pont said; "*Uncertainty rules the tax situation, the labor situation, the monetary situation, and practically every legal condition under which industry must operate.*" As we read that quote, there are clear similarities between that time and today. Without question there has been an increase in political, and by extension, regime uncertainty, due to the extreme polarization of partisan politics. In a recent Pew Research publication reports that "*Republicans and Democrats are more divided along ideological lines - and partisan antipathy is deeper and more extensive - than at any point in the last two decades.*" The consequence of this extreme partisan animosity is not just gridlock, but rather, a modern day political-Thunderdome - "*two men enter, one man leaves.*" It has become a winner-take-all contest, with the Affordable Care Act - a bill with sweeping social and economic repercussions, passed without a single Republican vote - emblematic of the increased political instability. As a consequence, "**regime uncertainty**" has been heightened on all policy fronts - tax, employment, immigration, health care, entitlements, etc. In our opinion, Higgs *regime uncertainty* is ultimately endogenous to central planning and statism. In the words of a real "central planner", King Louis XI the Prudent; "*He that cannot dissemble, knows not how to reign.*"

Ultimately, the mathematization of economics and the concomitant *assent* of central planning, has necessitated the ever-increasing management of practically all financial markets. And while all markets are to one degree or another, managed, one stands alone in this regard. Aside from the recent revelation by Michael Lewis in his new book 'Flash Boys' that the U.S. stock market is rigged in favor of high-speed electronic trading firms which use their advantages to extract billions from investors, the relationship between quantitative easing by the Federal Reserve and stock prices has been well documented. Referring to **Figure 6**, we can see that for the period prior to the implementation of quantitative easing (QE), the correlation between changes in the Fed's balance sheet and stock prices was **0.57**, or about the same as a **coin toss** (50/50). However, subsequent to the initiation of QE and the Fed's massive purchase of Treasury and mortgage securities, the correlation increased to **0.93**, or a near-perfect **one-for-one co-movement**. And according to Michael Cembalest, Chairman of Market and Investment Strategy for JP Morgan Asset Management, since the start of QE in March of 2009, **more than 100%** of stock market gains have taken place during those weeks the Fed purchased bonds, and conversely, during the weeks when the Fed did not buy bonds, the stock market declined. With

Figure 6



first quarter GDP coming in at -1.7% and the Fed on track to discontinue QE (again) by December, we cannot imagine what could possibly go wrong. Perhaps it's time to revisit some sage investment advice from Will Rogers: *"Don't gamble! Take all your savings and buy some good stock and hold it till it goes up, then sell it. If it don't go up, don't buy it."*

What about interest rate management? Obviously with the Fed's nearly 6-year-and-counting zero interest rate policy, short-term rates have been effectively neutered. How about long-term rates? Take a look for yourself. **Figure 7** illustrates the rolling correlation between the US Treasury 10-year yield and the 4-week change in the Fed's balance sheet. What becomes apparent is that long-term interest rates have

been positively correlated with the Fed's QE program, rising when the Fed is buying bonds, and falling when they don't. While at first this may seem counter-intuitive, the movement reflects the markets fear of inflation from the stabilizers money printing. Clearly correlation does not establish causation, nevertheless, it can reveal it.

*"The great crisis of our civilization is the outcome of this enthusiasm for all-round planning."* Thus wrote Mises in his book *"Human Action."* In this "New Normal" dominated by "New Economists", both the economy and the markets are, of necessity, increasingly **"managed."** As Hayek reminds us in his book *'Road to Serfdom'*, *"in a planned system we cannot confine collective action to tasks on which we agree, but are forced to produce agreement on everything in order that any action can be taken at all."* Under a **"planned system"**, the state can *brook no dissent*, instead all oars must pull together. Whether by taxation or regulation, coordination or equivocation, our economic outcome is more and more a function of Abba Lerner's "functional finance". Ditto for the financial markets, whether it be stocks, bonds, gold, currencies or commodities, increasingly, the **"fix is in."** However as Hyman Minsky reminds us, **'stability begets instability'**. We live in a high leverage-low growth world, overlaid with central planning. Nothing could be more inherently unstable. Yet the people have been "persuaded" that the state is God, able to ensure stability and security, thus able to annul uncertainty and so change man's status as underlings. Nevertheless, the concept of **unintended consequences** - what happens when a simple system tries to regulate a complex system - is one of the building blocks of economics. Adam Smith's **"invisible hand,"** is an example of a positive unintended consequence. Smith held that each individual, seeking only his own gain, *"is led by an invisible hand"* to promote an unintended end, the public interest. *"It is not from the benevolence of the butcher, or the baker, that we expect our dinner,"* Smith wrote, *"but from regard to their own self interest."* However, having dispatched the **"invisible hand"** of Providence for the **"dead hand"** of government guided only by probability, the question of the predictability of the future remains. *"Some men",* said Sir Thomas More, *"think the earth is round, others think it flat. It is a matter capable of question. But if it is flat, will the King's command make it round? And if it is round, will the King's command flatten it?"* For ourselves, we prefer to quote Jonathan Edwards, hailed by Encyclopedia Britannica as the greatest philosopher and theologian ever produced by America: *"Providence subordinates all changes in the affairs of mankind."*

**Figure 7**

