Redstone Advisors

Economic and Market Review

Fourth Quarter 2010

"You have missed the profit of your calamity; you have been made most wretched, and have remained most profligate."

Augustine of Hippo, 'City of God'

In his classical masterpiece 'City of God', Augustine of Hippo admonished the inhabitants of the recently fallen 'Eternal City' of Rome for their failure to learn from their adversity, laying bare the insidious and morally corrosive effects of a prosperity that is unrestrained by *"the interruption of any uneasiness or disaster."* According to Augustine **virtue is fortified by uncertainty** just as surely as **vice is emboldened by security**. [This observation was to be later reduced to a truism by Austrian economist F. A. Hayek as *"stability begets instability"*] In defense of his assertion, Augustine referred his Roman readers to a warning given nearly 600 years prior to the fall of Rome by their own Pontifex Maximus, Scipio Nasica Corculum. As Pontifex Maximus, Scipio, a man adjudged by the Senate to be Rome's best man, was charged with the administration of divine law, including the regulation of public morals. And it was in this role that Scipio, by force of argument, attempted to withstand another famous Roman, Cato the Elder, in a debate of great import on the advisability of the destruction of the strongest and wealthiest city of Rome's greatest rival, Carthage. Cato argued vigorously for the destruction of Carthage and the consequent enjoyment of security, while Scipio steadfastly opposed it, asserting that Roman virtue and its rightful companion liberty would be preserved only so long as Rome was hard pressed by an enemy without. Believing that a wholesome fear, **borne of uncertainty**, would be a fit guardian for Rome against the vice of unscrupulous ambition, Scipio instead feared **security**, that ***"enemy of weak minds."*** In the end the "weak minds" carried the debate and Carthage was summarily sacked in the Third Punic War in 146 BC, thus eliminating Rome's sole rival to global hegemony and with it the Republic. Hail Caesar!

The debate regarding the sustainability of a prosperity that is unrestrained by *"the interruption of any uneasiness or disaster"* is again being waged, and as before, the consequences are no less weighty. Unfortunately the debate is again being carried by the **"weak mind"** camp. Speaking for the stability faction, head 'stabilizer' Ben Bernanke was recently quoted as saying; *"Our first objective, the first goal that we have, is to meet our mandate to get price stability and maximum employment in the United States."* At this point, we must pause for effect, for 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 by definition uncertain, is both unknowable and immeasurable, the omniscience of the Fed notwithstanding. If you doubt this, you have only to consider the many forms of insurance we employ as a hedge against uncertainty: auto, home, life, health, casualty, disability, property, liability, catastrophic, unemployment, terrorism, FDIC, credit default swaps, *et al, ad nauseum*. But does the presence of insurance eliminate uncertainty? Certainly not. It

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merely changes the nature of the payoff. Yet price stability and full employment [security] are today, uncritically promoted as the **"holy grail"** of monetary policy, desirable as a means to permanent prosperity and wholly achievable by determined central planners. This is not only bad public policy [as Scipio reminds us], it is abysmal economics.

The concept of stability as an economic construct is derived from the fallacy promoted by inflationist's of all stripes that **"prices"** are merely a quantitative measurement of **"value",** which is itself derived from the more insidious error that value can in fact, be **objectively determined**. It is the outgrowth of this error which underlies the **theory of stabilization**. As such a proper theory of value is critical to a right theory of political economy. Addressing this very issue, the French economist Frederic Bastiat said; *"the theory of value is to political economy what numbers are to arithmetic."* Society ***is*** exchange and it is the **action of exchange** that gives rise to value. As we have stated on prior occasions, economics is merely the science of human choice. Acting man determines and chooses in an effort to attain a certain end, namely the improvement of his condition. Therefore economics must of necessity concern itself with what Bastiat referred to as **"wants"** and **"satisfactions"**, both of which are personal and particular and as such, non-communicable and immeasurable. **"Efforts"**, according to Bastiat, are the **bridge** between wants and satisfactions and while we cannot feel the wants or satisfactions of others [non-communicable], we can, by way of efforts, render service to one another, thereby bridging the gap between them. It is this transmission of efforts, this **exchange of a service** in which the concept of value is grounded. What we ultimately demand is an effort to satisfy our wants and in the performance of that service we acknowledge value. Relying on Bastiat again, we may define value as simply ***the relation of the two services offered***. From this it should be clear that the concept of **value is wholly subjective**, finding its foundation in neither materiality, nor durability, nor labor as those in the inflationist's camp claim, but solely in the **"utility"** of the service rendered. Action does not measure utility or value it merely **prefers and chooses** between alternatives. And the action of preferring and choosing is purely subjective and what is by nature subjective is also **immune to measurement**.

The introduction of money as a **medium of exchange**, while giving rise to the **expression** of this relation of exchange called **prices**, does nothing to alter the subjective nature of value. Money prices are simply **exchange ratios** between money and other goods and services, the determination of which is the subjective value judgments of the consumer. As such, **prices are not measured in money**, they merely **consist in money**. Nevertheless prices serve a critical role as they are the ultimate fact for a market economy, providing the basis for all **economic calculation**. By this we mean that prices determine the entire productive structure of the economy by **informing** producers what to produce, how to produce and in what quality and quantity. In this role they direct the investment of all capital components, including land, labor and commodities. Ultimately it is the consumer who determines what should be produced and in the words of Austrian economist Ludwig Von Mises, *"they are merciless bosses, full of whims and fancies, changeable and unpredictable."* We live in a world in which human action originates change and so long as there is human action there will be no stability in prices, only ceaseless alteration since the conditions which produce them are constantly changing. As a consequence we maintain that **uncertainty is the only certainty** and stand with the Austrians in asserting that the **stability of prices as an economic construct is an empty notion**. For there are in this world no such things as stability and security and no human endeavors are powerful enough to bring them about. To quote Voltaire: *"Doubt in an unpleasant condition, but certainty is absurd."*

Nevertheless, as the German socialist LaSalle once proclaimed *"the state is God"* and money is but the creature of the state. And so the state steps in where angels fear to tread, armed with its mandate for price stability, it purports to make us safe from the vicissitudes of the market. However the fact is that under the guise of promoting stable prices, the stabilizers at the Fed have been intentionally **manipulating prices** through the perpetual expansion of credit. Responding to a question on CNBC's Squawk on the Street segment in November about the efficacy of the Fed's current money printing operation, former Federal Reserve Governor Laurence Meyer bluntly retorted: *"It has nothing to do with printed money. It has nothing to do with the size of the balance sheet. It has nothing to do with the level of reserves. The only thing you need to focus on is what happens to **equity prices**, what happens to the **dollar**, and what happens to **borrowing costs**? That's what they are trying to* *do."* For those who may require translation, the Federal Reserve is intentionally attempting to manipulate the **price of stocks**, the **foreign exchange price of the dollar** and the **price of credit** [interest rates]. If you are wondering what happened to their *"first objective, their first goal"* of price stability, they threw that straw man under the bus a long time ago.

The years following the First World War were characterized by a great credit expansion initiated in the US by the newly established Federal Reserve which was founded in 1913. The expansion by the Federal Reserve was motivated not only by the desire to underwrite British inflation and to subsidize farmers, but also by the misguided and fashionable theory of a stable price level as the goal of monetary manipulation. The siren song of a stable price level had lured leading politicians and economists as early as 1911 when American economist Irving Fisher inaugurated his career as the unofficial head of the "stable money" movement. By 1921 the Stable Money League had been formed against the backdrop of falling prices during the short but severe depression of 1920-21. By redefining value as synonymous with price, the stabilizers endowed "prices" with a power far beyond their stature. Subsequent to this coup, the "official measurement" of prices was institutionalized through the creation of price indices beginning in 1917. After several iterations, the modern day consumer price index (CPI) was born. However it would be as naïve to misconstrue changes in the CPI as accurately representing changes in the purchasing power of money as it would to believe that the reason for the creation of the Federal Reserve was to pursue price stability rather than the institutionalization of inflationism. Writing for the stabilization camp in January of 1929, American economist Allyn Young confirmed the *raison d'être* for Central Banks when he urged all Central Banks to *"abandon their high gold-reserve fetish and to inflate to a fare-thee-well."* This they did with reckless abandon, with the Fed inflating the money supply from $37 billion to $57 billion, an increase of 54%, between 1921 and 1929. Their rationale for doing so was falling prices as confirmed by a declining price index. And as everyone today is well aware, falling prices, which has been semantically redefined as deflation, is the great scourge which Central Banks were bred to overcome.

In truth, falling prices which occur in the absence of any intervention or manipulation of the money supply are not something to be feared but something to be greatly desired. Under conditions of a properly functioning market economy, unburdened by excessive government interference, a tendency toward falling prices would be normative. That is not to say that there will be no cyclical fluctuations, for as we have already pointed out, change is the only certainty and as such, waves of optimism will be summarily followed by waves of pessimism since men are by nature, not omniscient. But absent a means to "monetize" the animal spirits into a paper-backed boom, the optimism in bank lending would be quickly "corrected" by the impact of rising delinquencies and defaults on bank capital. And in fact this was the case with prices during the decade of the 1920s which saw a considerable increase in productivity due to the introduction of many new technologies and the substantial accumulation of capital. Under these conditions, had there not been a massive expansion of the money supply, there would have been a significant decrease in the price of consumer goods and services, and thus a substantial rise in real wages and the standard of living. However given their mandate for maintaining stability and armed with their newly created standard of measurement, the Federal Reserve undertook a massive credit expansion which kept the prices of consumer goods effectively "unchanged" [stable] throughout the entire period. The policy of credit expansion which had been deliberately pursued under the guise of maintaining a stable price level provoked a fantastic boom which was ultimately doomed to fail in the Great Depression. Writing of this period in his book on the financial and economic history of the US, economist Benjamin Anderson said; *"Between the middle of 1922 and April 1928, without need, without justification, lightheartedly, irresponsibly, we expanded bank credit by more than twice as much, and in the years that followed we paid a terrible price for this."*

Warren Buffet once observed that *"price is what you pay; value is what you get."* Let's first briefly consider the "price" that we in the US have paid and the commensurate "value" we have received for the blessings of "price stability." Many people today may consider the events which culminated in the Great Depression as both unique and unavoidable. This belies an ignorance of the monetary history of America. While we have at various times in the past, written extensively on this topic, will not repeat that history in full here. Suffice it to say that for all intents and purposes, laissez-faire capitalism was replaced in the early 1900s by a new Progressive Era which fastened a welfare-warfare state on America giving birth to the statism we have today. The key to the new economic imperialism of the US was the creation of a Central Bank to **coordinate the inflation** and act as a lender of last resort to protect the interests of the banking cartel. It was, as we noted earlier, the massive expansion of the money supply by the Federal Reserve through bank lending that gave rise to the boom of the **Roaring 1920s** that ultimately went bust in the **Great Depression of the 1930s**. Writing about this period in their the book 'Banking and the Business Cycle' the authors concluded; *"The end-result of what was probably the greatest price-level stabilization experiment in history proved to be, simply, the greatest depression."*

Figure 1 is a chart illustrating the exponential growth in the US public debt since 1870. The chart denotes the steady deterioration in the monetary standard of the US, from the restraint of convertibility under the gold standard, to today's inconvertible paper standard, the history of the US monetary standard is one of continual decline. Two important dates are called out on the chart: 1913, the creation of the Federal Reserve which inaugurated the decline and initiated a period of transition of declining convertibility, and 1971, the closing of the gold window, denoting the end of the transition period and the start of our **experiment** with paper money. The nominal growth of the debt is represented by the red line. Two items stand out on this line across the passage of time. First, the marked acceleration in the level of debt outstanding after the closing of the gold window in 1971, and second, the marked increase in the trajectory of the debt expansion after the 1998 LTCM crisis and 2000 stock market collapse. The blue line presents the same data using a **logarithmic scale**. On a logarithmic scale, a given vertical distance represents the **same percentage change in price**. In other words, the distance on the logarithmic axis from 1 to 10 is the same on a percentage basis as the distance from 10 to 100, except the latter distance of 10 to 100 is ten times greater on the nominal axis. The key insight to be gleaned from the logarithmic chart is that the expansion of credit, i.e., **inflationism**, began immediately after the creation of the Federal Reserve and the abandonment of the convertibility restraint under the gold standard, and has continued unabated ever since. Looking only at the nominal increase in the debt as measured by the red line, it appears that the expansion of credit did not begin in earnest until post-1971. The problem is that because the nominal value of the debt has increased so dramatically since the 1970's, those numbers are **orders of magnitude** larger than the debt prior to that date. By using a linear scale to graph the nominal debt values, the information contained in the data points prior to that time are effectively lost. In our opinion, this chart graphically illustrates the **"law of increasing issue"** which follows from the naïve pursuit of a **policy of stabilization** under a paper-backed monetary regime. Commenting on this, former Federal Reserve Chairman Alan Greenspan remarked in 2002; *"Monetary policy, unleashed from the constraint of domestic gold convertibility, has allowed a persistent over issuance of money. Central bankers, having witnessed more than a half-century o chronic inflation, have confirmed that a fiat currency was inherently subject to excess."*

Figure 1

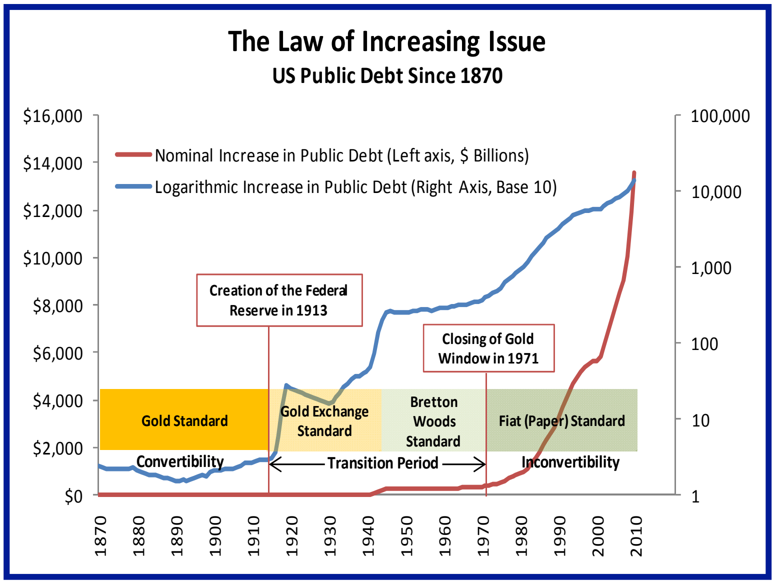
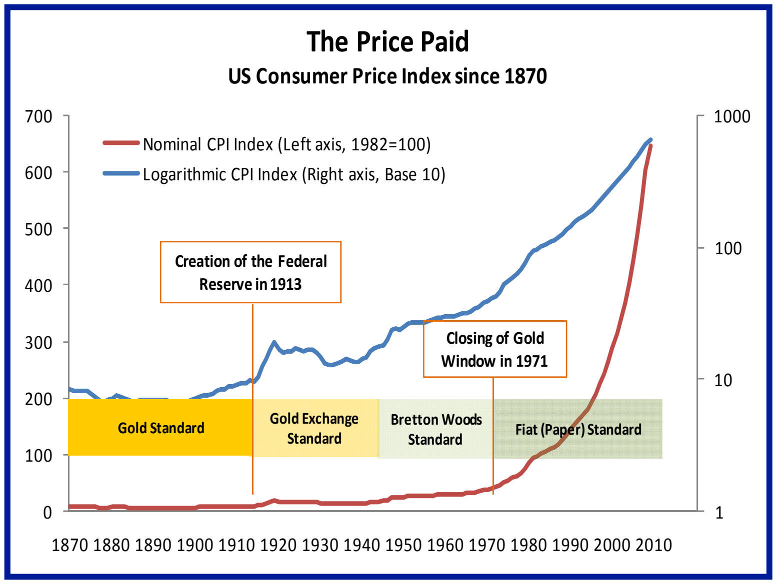
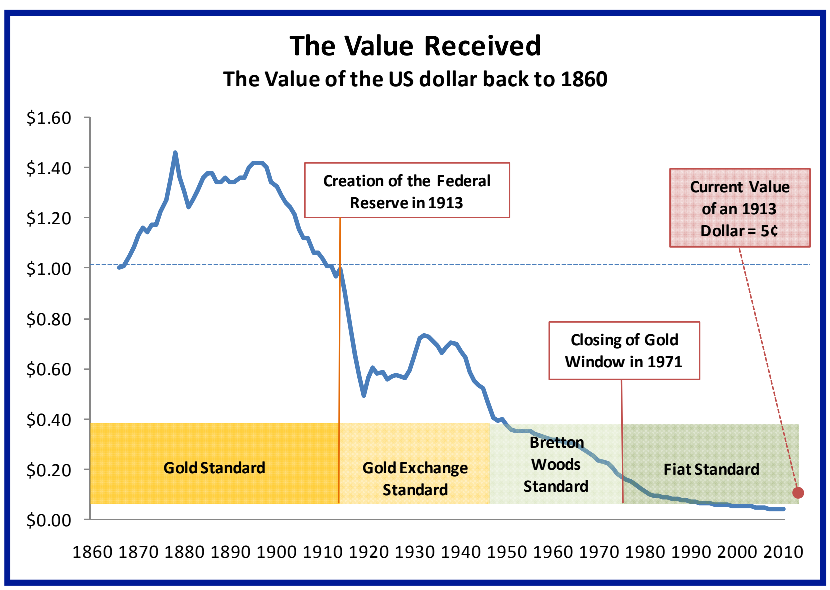


Figure 2



In fact the **"excess"** to which Mr. Greenspan alludes, is in fact the *end* for which **"stabilization"** was the merely the *means*. The sole purpose of a Central Bank is to promote the interests of the banking cartel by ensuring a perpetual expansion of credit from which they benefit. **Figure's 2** and **3** are, by way of construction, replicas of **Figure 1** except that the underlying data in **Figure 2** is the **consumer price index**, while in **Figure 3** it is the "**value" of the US dollar**. Given the subjective nature of value and the fact that prices are merely exchange ratios of those values consisting in money, no price index can pretend to accurately measure the purchasing power of money. Nevertheless, using the stabilizers own CPI clearly illustrates the long-term pernicious effects of the ***"persistent over issuance of money"***. As with **Figure 1**, while judging solely by the nominal CPI value (red line) it would appear that the bulk of the increase in **"official prices"** occurred subsequent to 1971, the CPI presented on a logarithmic scale shows the fallacy of this belief. The increase in prices as measured by the stabilizers has been accelerating since they obtained the **monopoly on money creation** and a **mandate for stable prices**. Recall that within a properly functioning market economy, underpinned by the protection of private property and a sound monetary system, the general tendency in the prices of goods and services is to fall due to productivity gains and capital accumulation. Under the **misguided theory of price stability**, Central Banks intentionally peg the increase in **"measured inflation"** (CPI) at **2 to 3 percent** to compensate for real economic growth and so "maintain stability". As Yogi Berra once quipped, *"In theory there is no difference between theory and practice; in practice there is."* In theory, 2 to 3 percent perpetual inflation may look like stability, but in practice the stabilizers **redirect** a disproportionate share of the **productivity gains** into the hands of those who consume and produce and a smaller proportion into the hands of those who only consume. Over time the expansion of credit works its mischievous effects by distorting price relations, resulting in the **concentration of wealth** and the **financialization of the economy.** And in the process **real incomes are eviscerated**. This is the insidious nature and the **real price** of **monetary inflationism**. As for the value, **Figure 3**, which illustrates the long-term impact of the perpetual expansion of credit on the dollar, represents the **"value"** received. Looking at the chart we can see that the current value of a 1913 dollar is around **five cents today**. To quote the British inflationist, Lord Keynes; *"By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens; and while the process impoverishes many, it actually enriches some."*

Figure 3

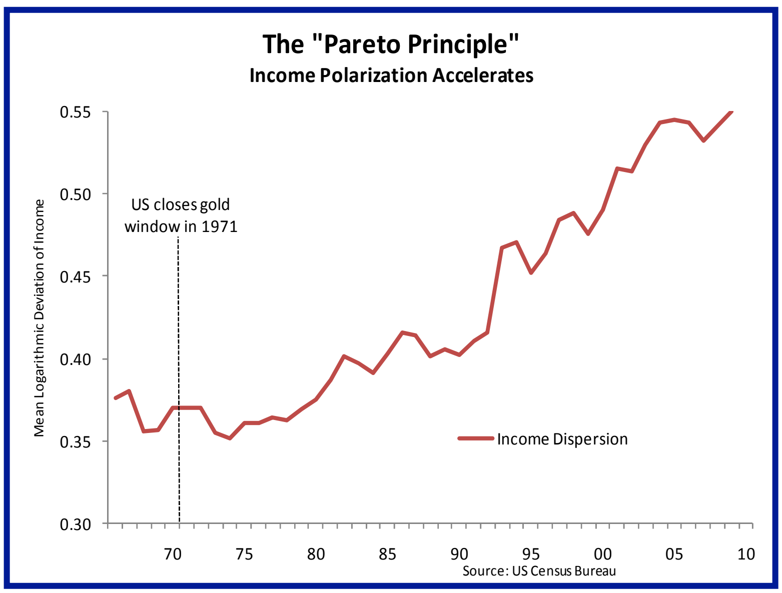


In our last Market Review, we dealt extensively with the nature of the injustice of arbitrary confiscation by the government via the evergreen expansion of credit and the resultant coming famine of income. We said;

> *"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."*

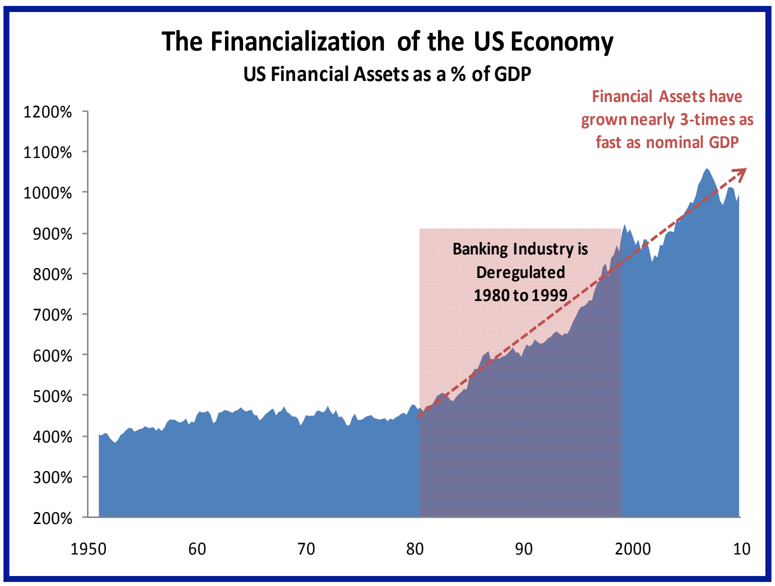
This polarization of income is aptly reflected in **Figure 4**. The **"Pareto principle"** which is also known as the **"80/20 rule",** was named for the controversial Italian economist Vilfredo Pareto who, based on his studies of European economies, believed that the distribution of income followed a power law whereby roughly 80 percent of the income would be controlled by 20 percent of the population. In fact, the **Pareto principle** is alive and well in the US and benefitting from the Fed's stabilization mandate. As reported previously, today the wealthiest 20 percent of households in the US owns 85 percent of all net household wealth and 80 percent of all stocks. It should therefore come as no surprise that the distribution of income has been skewed as well. Referring to **Figure 1**, we can see that the average dispersion of income is the US has been steadily widening since the final abandonment of the Bretton Woods gold standard in 1971 in favor of paper money. In fact, over the past 40 years, the average dispersion has nearly doubled. As Ken Gerbino notes in his book *The Great Deceit*, *"the bottom 90 percent of our citizens went from owning 65 percent of the income gains* [productivity] *in the 1960s to being squashed to 11 percent in the period from 2002 to 2008."*

Figure 4



Stabilization is a flawed theory based on a flawed premise regarding value and money prices. Not unlike the great experiment with paper money in France by the infamous John Law, the ultimate goal of the Keynesian gospel of **'something for nothing'** is to attain the Philosopher's Stone by **making money synonymous with wealth**. Nowhere has this been more evident than in the stabilizers' attempt to manipulate the prices of financial assets, particularly stock prices. Writing in a November Washington Post op-ed, Chairman Bernanke said; *"Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."* While the term "Bernanke Put" (previously "Greenspan Put") was first coined in 1998 in reference to the Fed's response to the derivatives crisis with the Long Term Capital Management hedge fund, the Fed's intentional use of monetary policy to place a floor beneath stock prices and so back-stop the economy during a crisis, has in fact, been the ***"modus operandi"*** of the Fed since its inception. Recall we described the doubling of the money supply between 1921 and 1929 to reinvigorate animal spirits in an operation described by then President of the New York Federal Reserve Benjamin Strong, as ***"giving the markets a little coup de whiskey".*** The rally was terrific but by 1929 it turned out to be just another story of collapse in the house of cards as had all the preceding nonsense about managing "price stability". Nevertheless, the long-term effects of attempting to equate money production with wealth production via the manipulation of stock prices has culminated in the **financialization** of the US economy whereby economic growth is now overly dependent on rising stock prices and all things financial. This effect is clearly illustrated in **Figure 5** which graphs the value of US financial assets as a percent of US nominal GDP. Beginning in 1980 with the passage of the Depository Institutions Deregulation and Monetary Control Act and culminating in 1999 with the passage of the Gramm-Leach-Bliley Act, the banking industry underwent a period of extensive deregulation, a key component of which was the repeal of the long-standing Glass-Steagall Banking Act of 1933. With the repeal of the Glass-Steagall Act, the Chinese wall separating banking on **Wall Street** from **Main Street** was swept away, eliminating the distinction between lending and investing. Since that time, Wall Street has achieved a ***'Masters of the Universe'*** status, serving as the intermediation conduit by which the credit expansion is **"monetized"** in the **price of financial assets**. In this way, the symptoms of inflation are **"hidden in plain sight"**, not in a rising price index (CPI), but in rising asset prices. This is reflected in **Figure 5** where we can see that subsequent to the start of deregulation in the banking industry, financial assets as a percentage of US GDP **soared nearly three-fold** from around **400 percent** of GDP to nearly **1100 percent** in 2007. Rising stock prices have become the source of the Bernanke's "virtuous circle" from which all economic benefits are perceived to flow. Following after the Keynesian fallacy of inflationism, the stabilizers, by redefining price as value and money as wealth, have unwittingly invested the financial industrial complex with veto power over economic growth. Paraphrasing the Austrian economist H. A. Hayek; *"The dilemma created by inflationism is that as the economy becomes adjusted to a particular rate of inflation, the rate must itself be continuously increased if symptoms of a depression are to be avoided. Ultimately the choice is between a runaway inflation and an extensive depression. To inflate then, is to leave the economy grasping a tiger by the tail."*

Figure 5



This then is the situation faced by the stabilizers today, the ultimate paradox of inflationism, built on the quicksand of paper money and aided and abetted by a "mandate" to pursue the chimera of stable prices. They have a tiger by the tail and they dare not let go. For should the increase in the expansion of credit and money come to a halt, let alone contract, an inflation regime can morph into a debilitating deflation regime *a la* 1930s America or Japan. And if monetary history teaches us anything, it is that deflations are events to be avoided, not cured. For deflation, properly defined, is a contraction of credit and money and as such, is the ***Achiles' heel*** of a debt-based monetary system. All the virtues of leverage which are exalted in the boom, apply with equal ferocity in the bust. Through the dislocation of prices, the credit-based boom results in a misallocation of resources and a distorted productive structure, which should it cease, results in a correction of the mainvestments in the form of a depression. This, as we have maintained for years, is the real reason behind the unprecedented actions taken by the stabilizers, particularly the quantitative easing program (QE), since the onset of the financial crisis in 2007. **Figure 6**, which graphs the total dollar volume of outstanding bank loans in the US, illustrates the urgency of the stabilizers fear of falling credit. As **Figure 6** highlights, the volume of total outstanding bank loans actually declined following the onset of the 2007 financial crisis. Left unattended, the contraction in bank lending caused by defaults and non-renewal of credit extension, could permanently impair the capital base of the banking interests. As economist David Rosenberg trenchantly observed, ***"Deflation is the fact, inflation is the fear."***

Figure 6

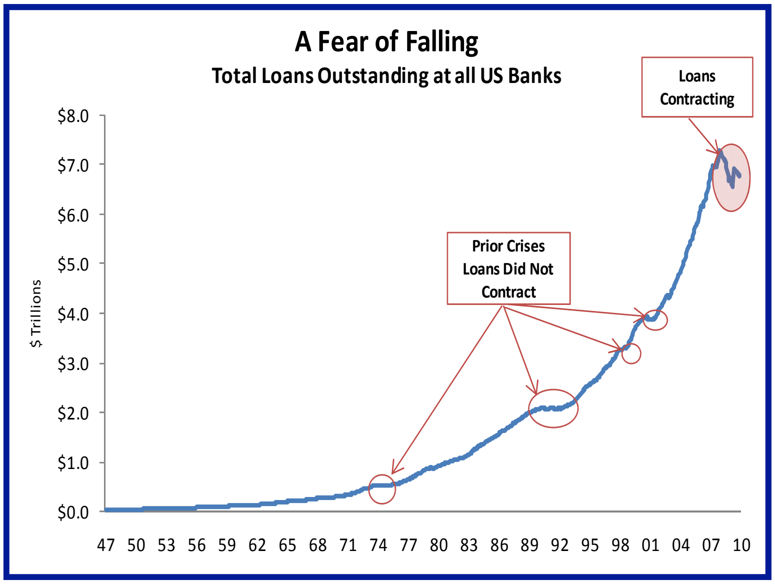
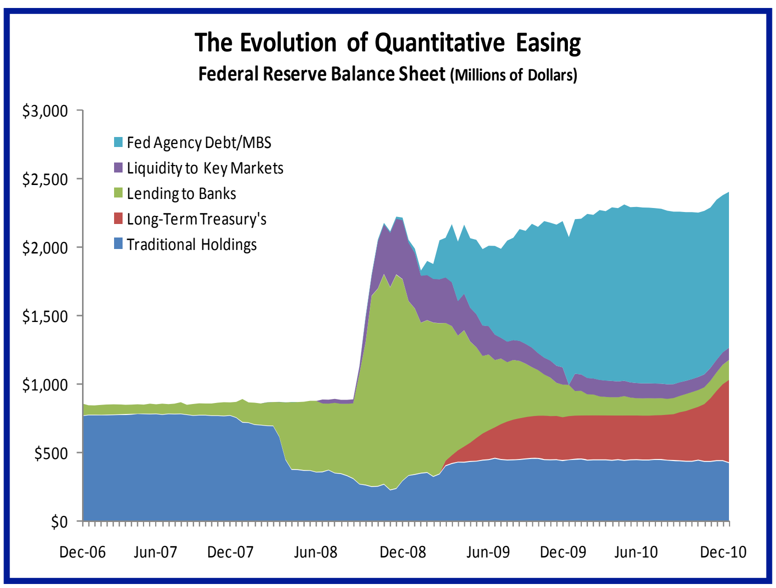


Figure 7

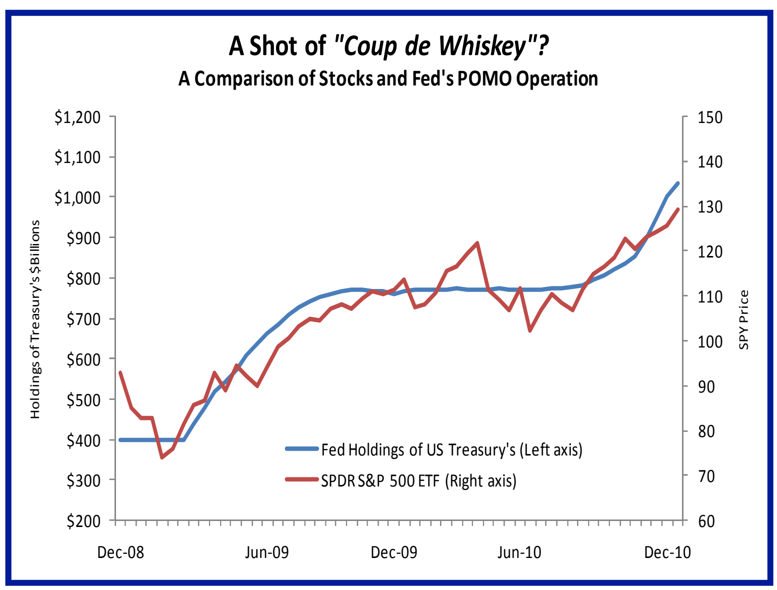


Nowhere is the **"fear"** of hyperinflation more clearly manifest than in the massive expansion of the Federal Reserve's balance sheet. (**Figure 7**) For if the **money multiplier theory** of lending were correct, the doubling of the reserve base would be followed by an exponential increase in credit issuance by banks seeking to profit for the availability of new funds to lend. However, as we have discussed previously, the money multiplier is impotent. What, then, is the stabilizers purpose in employing quantitative easing?

That purpose has evolved in the years since the program was first initiated and this is reflected in the changing composition of the Federal Reserve's balance sheet as illustrated in **Figure 7**. Initially the Fed's program of QE mostly involved the **provision of liquidity** in the form of emergency lending to banks and other financial institutions. However, despite the massive emergency lending during 2008 and 2009, banks continued to experience losses on mortgage loans made during the preceding boom years. In other words, the underlying problem was one of **solvency**, not liquidity. As such, the Fed switched the focus of its QE to supporting the mortgage market directly. The Fed embarked on a program to purchase **$1.6 trillion** in Treasury securities, GSE debt and GSE mortgage-backed securities on the open market in an effort to reduce interest rates and spur demand. Overall, the impact of the Fed's QE program has not engendered the hyperinflation than many have feared. Instead it has put the mortgage market in a kind of "**managed equilibrium"** whereby the market's tendency to liquidate losses has been offset by the Fed's efforts to prevent it. Yet this equilibrium is a precarious balance. Millions of homes stand empty, home-buying intentions have collapsed and mortgage applications are down dramatically from already depressed levels of a year ago. And the raw material for foreclosures – delinquencies – remains on the rise, with estimates of homes with loans in delinquency or at some stage of foreclosure as high as **8 million**. Equally worrisome is **negative equity** as an estimated **5.5 million** US households are under water on their mortgages by at least 20 percent. All of this contributes to the expectation that despite the record collapse in home prices thus far, home prices will continue to decline for at least another year or perhaps two. The stabilization of housing prices at current levels is simply not possible given the volume of real and shadow inventory. As economist David Rosenberg put it: *"If home prices don't decline at least another 10 percent, then the laws of supply and demand will end up being repealed as far as it pertains to residential real estate."*

Where then have the stabilizers been successful with their QE program? With their impact on the prices of financial assets in general and equity prices in particular. **Figure 8** graphs the Federal Reserve holdings of US Treasury's since the initiation of their purchase program via the Fed's permanent open market operations or POMO. While we would be the first to caution that "correlation does not equal causation", there is, nevertheless a compelling argument for a causative link between the Fed's POMO activities and rising stock prices. Jim Bianco of Bianco Research refers to this as the Fed's **"portfolio balance theory"**. Primary dealers submit offerings to the New York Fed and those whose bids are successful receive cash in exchange for Treasury bonds. The new money dumped on the Street is not recycled back into the very Treasury's they just sold, rather it is arbitraged into risky assets such as stocks, emerging bonds and commodities. At the end of the day, the Fed is agnostic about where the money goes as long as it flows into the markets and impacts prices in the form of a modern day ***"coup de whiskey."***

Figure 8



Writing about the impact on volatility from the Fed's program of stabilization, Artemis Capital Management, in an excellent piece entitled *'The Great Vega Short – volatility, tail risk, and sleeping elephants'*, offers a well constructed metaphor for understanding the stabilizers current policy of postponement via the printing of money. They wrote;

> *"In theory the Federal Reserve is now the largest volatility trader in the world because current monetary policy is akin to shorting massive amounts of volatility and assuming tail risk. The current regime of monetary and fiscal stimulus is similar to writing a naked put on the entire financial system with margin backed by the US debt. The premium received from the sale of the naked put is financed via demand for our debt and redistributed to the investor class to re-flate underlying asset prices and depress volatility. The theory is that the reinvestment of this premium by investors into underlying risk assets ensures the Fed's naked put is never exercised. In effect, the Federal Reserve is constantly shorting vega on a systematic level. This stimulus regime socializes "tail risk" to generate short-term prosperity. If asset prices drop the Fed is forced to sell more volatility to artificially support prices. This will work as long as (1) asset prices do not collapse too far or; (2) taxpayer funded margin is unlimited. If either of these two conditions are not met the asymmetrical return distribution of the strategy will result in complete ruin. It is a martingale process, similar to constantly doubling down your bet while gambling. It works only if your bankroll is unlimited."*

The stakes are high and the Fed is **"doubling down"** to ensure the **"stability"** of the financial markets as they are key to their **policy of postponement** through the manipulation of financial asset prices. However as stated previously, we are not in the hyperinflation camp, believing instead that the stabilizers will be successful in pursuing what Vijay Boyapati has termed a **"controlled deflation"**. As stated earlier, the banking cartel prefers a monetary policy which allows them to profit from the activity of the economy in a subtle and insidious manner. Therefore they recognize that policies that will lead to hyperinflation will also bring about the destruction of the monetary system from which it profits. Given that the Federal Reserve was created by and for the benefit of the banking cartel, it is not likely to pursue a policy that would be detrimental to their interests. As such they will continue to pursue a policy of postponement whereby they hope to slowly write off the malinvestments over an extended period of time – a controlled deflation rather than an untrammeled one. We have referred to this as a **"rolling recession",** an extended period of high structural unemployment and slow economic growth, accompanied by the long, **slow decline into mediocrity** that has been the fate of all nations who have followed the siren song of a perpetual prosperity, unrestrained by *"the interruption of any uneasiness or disaster"* under the guise of security and stability.

Ultimately, both Scipio and Hayek were right. **Stability begets instability**. The evergreen expansion, like the rising tide that lifts all boats, has been the source of the reduction in volatility and 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 stimulus provides the markets with the liquidity to re-flate underlying asset prices and so dampen volatility. However, as the story of Scipio reminds us, **"success"** at stabilization carries its own risks. Currently the markets are awash with liquidity. Should asset prices collapse too far or the expansion of credit is interrupted, the hazards submerged by this tide of liquidity would be revealed. As Warren Buffet once observed; *"It is only when the tide goes out that you learn who's been swimming naked."* Stability, as an economic construct is an empty notion and the way in which financial markets price financial assets reflects a "*heroic assumption that the unknowable can be known."* For that reason, we continue to hold that investment decisions should continue to observe the **law of uncertainty** which says that the **severity of the consequences**, not the **probability of occurrence,** should drive the decision. *"For when they say, "Peace and safety!" then sudden destruction comes upon them."*