Redstone Advisors

Economic and Market Review

Fourth Quarter 2011

"Please, sir, I want some more."
'Oliver Twist' by Charles Dickens

Ever since man's expulsion from the garden, he has never ceased to struggle against his curse; *"by the sweat of your brow shall you eat bread till you return to the ground."* Work, or labor as economists would later come to refer to it, is the immutable limiting factor in the resolution of man's eternal economic struggle against **scarcity**: the satisfaction of unlimited wants with limited means. But man, in his own vanity, has purposed to defy his sentence and seek respite from his 'irksome toil'. And so while it has been justly said that in His providence, *"the Lord giveth increase"*, man, in his impatience, **devised credit**. Originally conceived as a means to circumvent the curse and so expend labor in advance, credit, so long as it was fully backed by unspent labor (savings), engendered no real mischief. Towards this end, men and nations, over time, determined with varying degrees of fidelity, to establish their money and credit upon the firm foundation of gold. However, with the coming of age of the **democratic welfare state**, came the realization that the limits imposed by gold are incompatible with the chronic deficit spending which is the hallmark of the modern welfare state. And so out of Lassalle's epiphany that *"the state is God and Santa Claus at the same time"*, came the cry to abandon our fetish with gold and sound money and inflate to a fare-thee-well. Suddenly, the same government which had once held forth gold as the only safe store of value and so the surest defense of personal liberty, became the avowed enemy of gold. As a result, **sound money** was overthrown and the unrelenting discipline of gold was supplanted by the more democratic discipline of the printing press. Armed with an inexhaustible supply of paper and ink and an unfaltering belief in the expediency of a willing central bank to forestall any contractionary impulse, today's stabilizers have thus far been able to circumvent Gresham's Law and so avoid the dust bin of history which is littered with man's recurring experimentation with paper money. Yet despite his pretended success with printing press prosperity, man's way with the curse will ultimately be as it has always been; he flees and it pursues him. That an encounter may again be drawing near, is, we believe, evinced by the expanding global crisis in money and credit and the recurring headlines of an "Armageddon Narrative". It was the poet Thomas Campbell who wrote that ***"coming events cast their shadows before"***, and severe though the current global crisis may be, it is in our opinion, but a shadow of things to come. Writing during the Great Depression and echoing our concerns today, Freeman Tilden observed that ***"the world has several times squandered itself into a position where a total deflation of debt was imperative and unavoidable."*** We fear we may be approaching one more such receivership of civilization.

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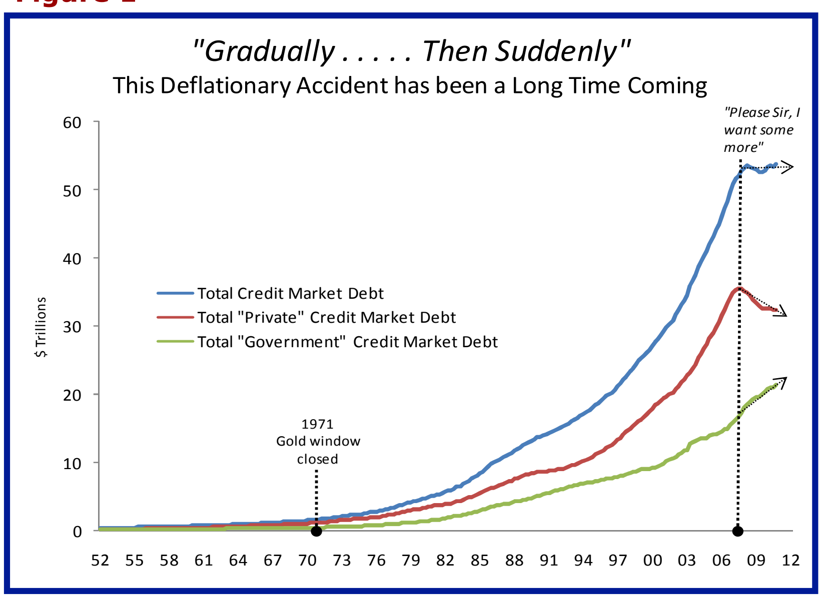
Yet how have we arrived at this seeming precipice of global bankruptcy? Hemingway, in his book 'The Sun Also Rises' provides the answer: ***"Gradually . . . . then suddenly."*** As we have opined for years, the current global conflagration is the inexorable outcome of a **process**, not an event. A process of decline we have referred to as the **'Monetary Sin of the West'.** A process which can best be characterized by the irresistible Keynesian siren song of *something for nothing*, and which is ultimately grounded in a defective philosophy of money and wealth. In fact, *'the great confusion'* which continues to be embraced by stabilizers of all stripes today is to confuse money with wealth. However just as all action is the product of thought, even so wrong thinking will lead to wrong acting. By confounding money with wealth, the stabilizers have pursued a policy of **inflationism**, a policy whose aim is to increase wealth through the perpetual emission of credit money. This insidious process which began **"gradually"** with the establishment of the Federal Reserve and the national income tax in 1913 and the subsequent overthrow of sound money in favor of a **"managed currency"**, a feat that was finally completed with the closing of the gold window in 1971, has, after forty years of unhampered operation, brought us ***"suddenly"*** to the financial abyss we face today. Not unlike the impertinent request of Oliver Twist, the cry today by impoverished governments for ***"more"*** credit money has had the salutary effect of unmasking the long hidden bankruptcy of a ***"printing press prosperity."***

Referring to **Figure 1**, we can see that subsequent to the closing of the gold window in 1971, the era of unrestrained credit expansion began in earnest. Over the 37 years between 1971 and 2008, the policy of inflationism met with delirious success as total credit market debt in the US grew from $1.5 trillion to $53.6 trillion, an increase of over **$52 trillion** representing an annualized rate of increase of **10.1 percent**. Over the same period of time, nominal GDP increased just $13.3 trillion, from $1.1 trillion to $14.4 trillion, an annualized rate of increase of 7.1 percent. And while at first blush the 3 percent difference in the annualized rate of increase appears small, as the chart reveals when that increase occurs relentlessly over 37 years, Einstein's observation regarding the power of compounding is fully vindicated. However the chart also reveals that there is *something very wrong in the state of Denmark*. After peaking at $35.5 trillion in the third quarter of 2008, **total private credit market debt has been on a decline**, contracting by **$3.3 trillion**, or nearly 9 percent, to a level of $32.3 as of the third quarter of 2011. This is a **debt deflation**, the 'Achilles' Heel' of a monetary system where all money is debt. It has been in response to this ***"sudden"*** contraction in the expansion of private credit that the stabilizers have been obliged to *step once again unto the breach* in a no holds barred effort to prevent a debilitating debt deflation in the total level of outstanding debt. Towards this end **total government credit**

Figure 1



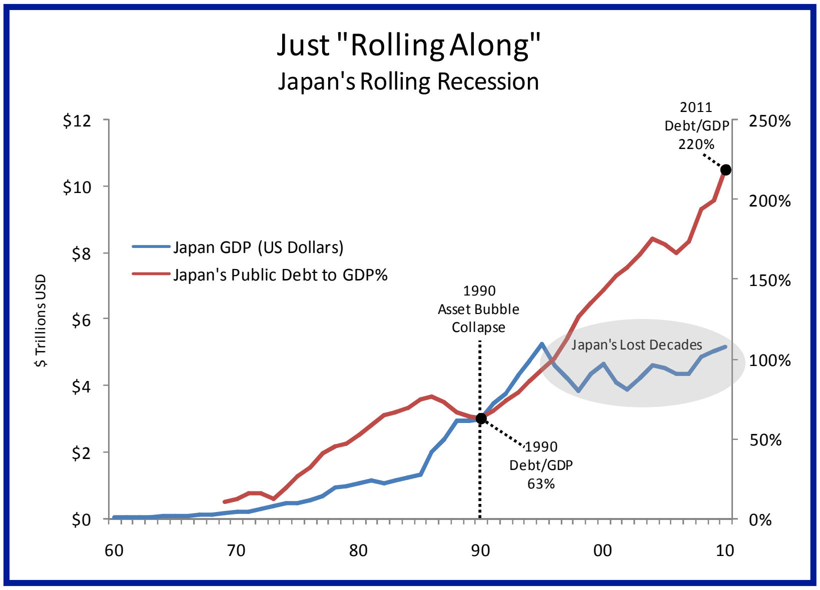
market debt has increased nearly **$4 trillion** since 2008, rising from $17.4 trillion to $21.3 trillion, an increase of over **22 percent**, the majority of which has been **monetized** by central banks. This unprecedented level of intervention has *stabilized* the total level of credit market debt, thus far forestalling an outright debt deflation. And while the stabilizers are fully aware of the increasing **systemic risk** associated with the issuance and monetization of massive levels of government debt and liquidity programs, they are also cognizant of the fact that if once a debt deflation gets fully underway, we must with both Dante *and* Japan, ***"abandon all hope, ye who enter here."***

As we have oft repeated, the sole precondition for a debt deflation is the massive accumulation of debt. And as **Figure 1** illustrates, accumulate we have. However the rationale for this accumulation of debt can be attributed to the aforementioned confusion of money and wealth. And despite the scholarly tomes that have been penned over the centuries purporting to lay bare the essence of money, judging from the current proclivities of the stabilizers the world over, one might rightly conclude that money, to disabuse Churchill, is a ***"riddle wrapped in a mystery inside an enigma."*** Yet we would insist that the greatest challenge in unraveling money attends not to its nature, but its nurture. That is the greatest problems lie not with the definition of money, but rather its expected vocation. Towards this end, we recommend the writings of Frédéric Bastiat whose common sense approach combined with his use of allegory, *puts the cookies on the bottom shelf* so that practically every thinking person can pierce the shroud of academic fog which envelopes the concept of money. Money, at its' root, is merely an irrevocable claim against wealth, not wealth itself. It *should* arise naturally from the process of free exchange between producers and consumer. As such its' sole function is that of a facilitator of this exchange. Wealth, on the other hand Bastiat reminds us, *"is the mass of things we produce by labor in order to satisfy our wants."* These things, whether they are food, clothing, houses, or fuel, all come from *"more or less skillful labor exerted upon a more or less liberal nature."* And a country is only wealthier to the extent that it produces more of the things that people want. Multiplying the instruments of exchange by decree, cannot multiply the things exchanged. Or as Bastiat challenges us to consider before accepting the dogma of the high priests of money, *"do the things purchased create themselves?"*

How then do we obtain them? As Bastiat rightly observes, there are only two ways by which the wealth essential to our preservation may be secured – production and spoilation. Spoilation or theft arises from the persistent efforts of people and governments to live and prosper at the expense of others. Monopolies are a particularly heinous form of systematic spoilation enabled by governments. A monopoly or grant of exclusive privilege is obtained through the establishment of a law or regulation prohibiting competition, thus violating the freedom of exchange by conferring an unjust advantage on one party over another. And no other monopoly has been as injurious to the liberty and economic well being of a people as the money monopoly enjoyed by central banks. These quasi-private institutions owned by the banking cartel whose interests they protect, suffer no political oversight and are accountable to no one. In his book, 'End the Fed', Ron Paul warns: *"There is no greater threat to the security and prosperity of the United States today than the out-of-control, secretive Federal Reserve."* The ultimate outcome of a money monopoly is to **reallocate wealth** through its transfer from one pocket to another. However as stated on prior occasions, 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,"*** 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."***

That moment may be fast approaching. Honest credit, when fully backed by real savings, can be an agent for economic growth and capital formation. However unbacked or fiat credit, leads to an increase in **money claims** against existing wealth resulting in **impoverishment** due to the **diversion** of wealth in the form of **debt service** to the holders of the new fiat money. Thus the expansion of **nonproductive debt** burdens the economy with rising interest and amortization obligations, directing a growing proportion of economic resources away from consumption and productive investment to debt service. Not unlike the medieval practice of bloodletting, this dynamic of a ***"death by a thousand cuts"*** is at the core of the process we have termed the **financialization** of the economy. Financialization brings about the perpetual impoverishment of the productive capacity of the economy by eviscerating long-term economic growth potential below "stall speed," resulting in malinvestment, high structural unemployment, declining real incomes, and the polarization of wealth, while at the same time increasing the **instability** of the asset price bubble supporting it. In sharp contrast to **industrial capitalism** which adds to the existing stock of capital through the return of real profits on production and sales, financialization siphons off economic surplus, not by employing labor to make useful things for sale at a profit (wealth creation), but by enticing labor and industry into what economist Michael Hudson has termed a form of **"debt peonage."** By the aforementioned process of gradualism, the errors flowing from the confusion of money and wealth, a **planned economy** and **managed money**, have fastened onto the economy, draining its vitality, leading to the perpetual malaise of exploding sovereign debt levels and rolling recessions, *a la* **Japan**. Referring to **Figure 2**, we can see that shortly after the collapse of Japan's asset bubble in 1990, GDP has been mired in a relentless **rolling recession** that has lasted nearly 20 years. At the same time, the unprecedented level of fiscal and monetary stimulus expended in an attempt to revive economic growth, has driven Japan's public debt to GDP ratio from a manageable **63 percent** in 1990 to an unsustainable **230 percent** in 2011, the highest in the developed world. In our opinion, it would be well for the stabilizers to study **Figure 2** and reflect on the most elemental law regarding the survival of a parasite; **Don't kill the host**.

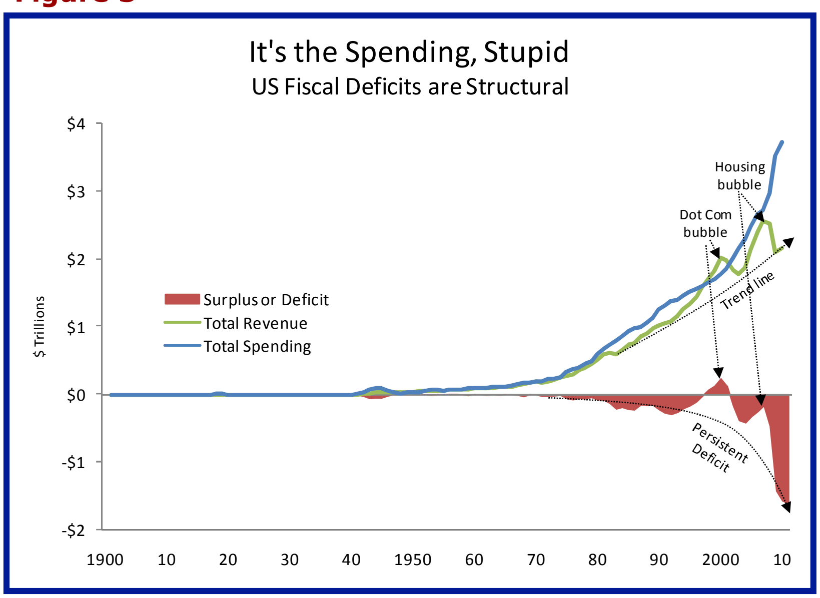
Figure 2



That the "host" governments of the West in general, and the US in particular, have been impoverished by the financialization of the economy hardly requires explanation. From Europe to Asia to the US, the fiscal condition of nearly all developed countries can only be described as **dysfunctional** and the plans put forth to repair them as ***"the road to serfdom."*** Referring to **Figure 3**, we can see that despite the reassurance of political sycophants, the fiscal problem in the US is due entirely to out of control spending and as such, the deficits are **structural**, not cyclical. In fact, subsequent to the closing of the gold window and the implementation of the **Great Society**, the fiscal balance of the US has been in a **persistent deficit status**. The only respite from this condition occurred over the four year period between 1998 and 2001 and was due **solely** to the increase in **capital gains tax** associated with the credit induced **stock market bubble**, not with a decrease in spending. After the collapse of the Dot Com bubble in 2000, tax receipts dutifully collapsed back toward their long term trend. As can also be seen in the chart, the same scenario repeated itself during the housing bubble between 2004 and 2007, except that despite a temporary improvement in revenues due again to an increase in capital gains tax, this time the fiscal balance remained mired in deficit reflecting the downward pull from the inertia of Keynesian inflationism.

But as dire as the fiscal trend may appear from **Figure 3**, it markedly understates the true fiscal imbalance of the US. According to the Government Accountability Office (GAO), the **reported cash deficit** for FY 2011 was $1.3 trillion, or 8.7 percent of GDP. However if the government was held to the same accounting rules as corporate America, the GAO reports that we would have to **increase** the reported deficit of $1.3 trillion to **$4.2 trillion**, or fully **28 percent of GDP** to account for the cost of the **unfunded promises already made**. The GAO further reports that **$1.5 trillion** of the $2.9 trillion increase simply reflects the **aging** of all 312 million Americans by **one year**. In other words with the current promises in place, the government could take a one year hiatus from all spending and we would still have a $1.5 trillion deficit. Given the demographic profile of the US and the **irreversible transition** of the baby boom generation into retirement, our **free-until-accounted-for promises** are set to explode higher. *"But wait, there's more."* The GAO *qualified* their report by stating the cost projections for Medicare are likely to be understated because by law, the GAO was required to make two highly improbable assumptions. One that the so-called **"doc fix"** which Congress has ignored for years will actually be enforced and second, that **"Obama Care"** will actually *reduce* health care costs. When these two heroic assumptions are removed, the reported deficit for FY 2011 rockets from a revised $4.2 trillion to a staggering all-in deficit of **$13.7 trillion**. That is a one year deficit equal to **91 percent of GDP**. Clearly as problematic as the deterioration in the current US fiscal condition is, and by extension the sustainability of the **"print and extend"** policy of monetization, when we consider that the impact of the coming escalation in age-related spending has not been factored in, the current partisan debate over budget cuts totaling less than **1 percent** of total government expenditures is tantamount to ***rearranging deck chairs on the Titanic***. Nevertheless, upon release of the FY 2011 fiscal deficit, Jacob Lew, director of the White House Office of Management and Budget said in a statement worthy of Lewis Carroll, *"This report confirms that we cannot waste any time in jump-starting economic growth and job*

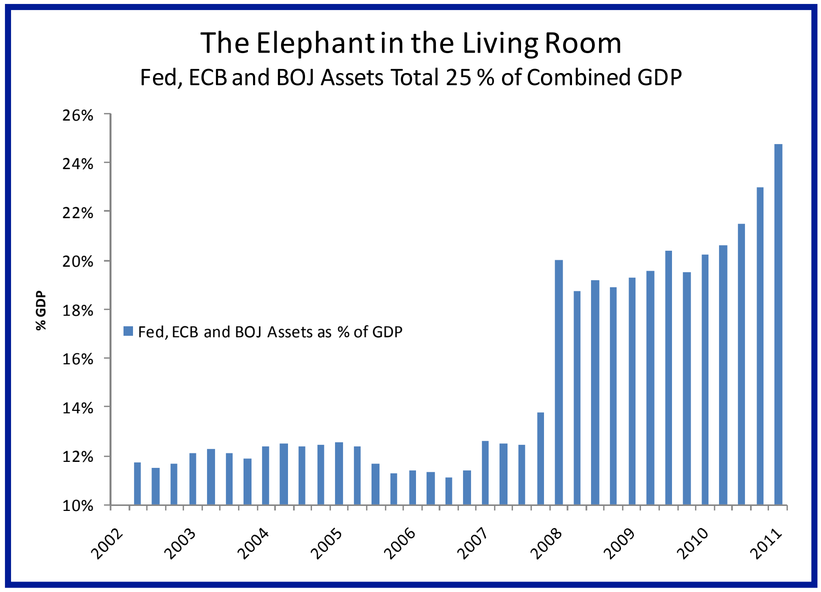
Figure 3



creation [read stimulus] *to lay the foundation for a stronger economy and lower future deficits."* Is it just us or has Washington fallen down Carroll's rabbit hole. In the words of Ron Paul, ***"If the debt is the problem, and it is, how can more of it be the solution?"***

Setting aside the issue of the marginal utility of any additional stimulus, it should be remembered that the majority of the trillions in new debt already issued by the sovereign governments of the developed world over the past several years to bail out the banking cartel and so forestall financial Armageddon, has not been financed out of savings, either foreign or domestic. Instead they have largely ***fallen down the black hole*** of monetization by central banks. Referring to **Figure 4**, we can see that the total combined assets of the **"Big Three"** central banks - the Federal Reserve, the European Central Bank and the Bank of Japan - currently totals over **$8 trillion,** a sum equal to **25 percent of their host GDP**. This is more than double the level recorded in 2007. The rapid expansion in central bank balance sheets was conducted to monetize various assets, and in the process to **"lift and support"** equity prices and leveraged speculation while also providing a backstop to impaired banks, particularly in Europe. With the Big Three central banks now accounting for up to **25 percent of developed world GDP**, the wonder should not be that there has been a modest uptick in measureable GDP, but rather that there has been so little of it. As this chart points up, the massive asset monetization by central banks to hold back a debilitating debt deflation is the **"elephant in the living room"** that nobody talks about. Anyone who still believes that there will be an **"exit strategy",** whereby the central banks will unwind these massive purchases, either actively or through attrition, had better awake to the reality that ***"the emperor really doesn't have any clothes."***

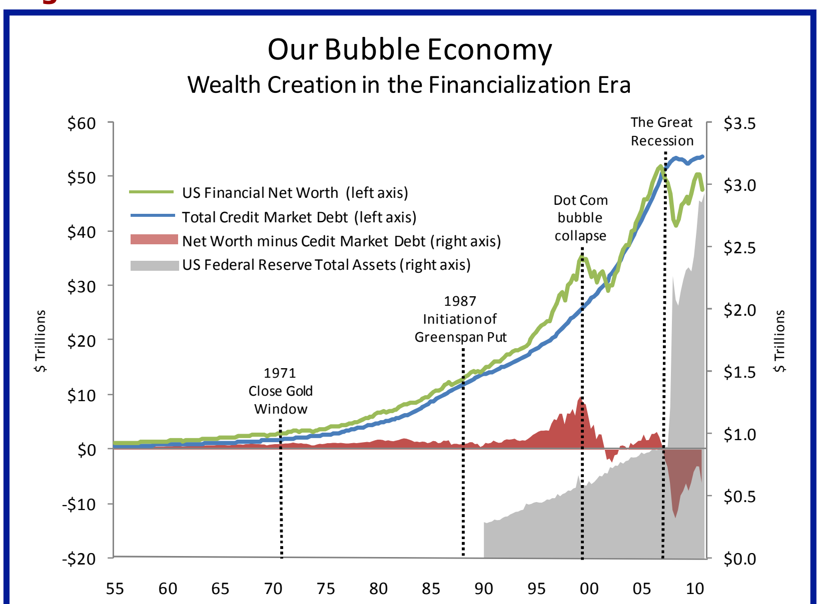
Figure 4



Through our insatiable profligacy, the US, like Great Britain and Rome before us, should by now have dashed itself to pieces against the *rock* of sound money. Yet this is the **"new normal."** A label that is in our opinion, far too sanguine as it belies the tectonic shift that has actually taken place in the way the world works. We prefer Charles Hugh Smith's description of a ***"fragile hothouse economy"*** where the slightest disruption to the ***"persistent drip line"*** of monetary intervention would cause the all-important but fragile financial sector to wilt and die, dragging the rest of us into the *"mother of all"* debt deflations. We now live in a Keynesian world unmoored from the confines of scarcity, a world of planned economies and managed currencies, a world in which economies have become overly dependent on the financial sector and leveraged speculation. In this "bizarro world", the stabilizers dare not reduce their all-in commitment to the global Guttenberg games. As a result the stabilizers have unwittingly committed themselves to a strategy of **"mutually assured destruction"** or MAD, the goal of which apparently is to prevent the destruction of the banking system by destroying the credit of the sovereigns'. Nowhere is this inanity more visible than in the European Union where the **cross-pollination** of sovereign debt and debt guarantees makes it impossible to unravel the interrelatedness between sovereigns and banks in the collapsing ponzi scheme. In a recent report on Global Financial Stability by the IMF, the authors, addressing the European banking crisis concluded that the *"increase in sovereign credit risk is amplified through a network of highly interconnected and leveraged financial institutions."* The report went on to state that it would be necessary to *"restore the long-term sustainability of the sovereigns public finances to reduce pressure on banks."* However *"some banks, especially those exposed to riskier public debt, may also need more capital."* Unfortunately *"the amount of new capital needed would also depend on the credibility of the policies pursued to address the roots of sovereign risk."* Oh what a tangled web we weave. In this daisy-chain bailout drama, we have insolvent sovereigns bailing out insolvent banks. Watching the unfolding crisis in Europe is, to lift a line from the movie 'Operation Petticoat', *"like watching a strip tease. Don't ask how it's done, just enjoy what's coming off."*

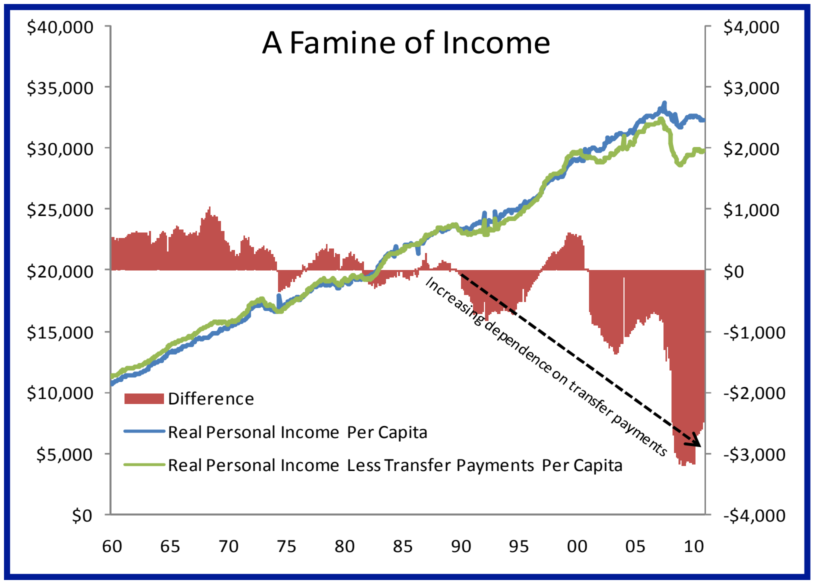
Today, wealth in our **"bubble economy"** is based on the ever increasing activity of **debt leveraging** in search of capital gains. Referring to **Figure 5**, we can see this underlying dynamic as a feedback loop between rising fiat credit and financial net worth. Subsequent to the closing of the gold window and the initiation of the "Greenspan Put", total credit market debt accelerated rapidly, underwriting a corollary rise in financial net worth. By encouraging and enabling speculation, the stabilizers discourage thrift and industry. For as anyone who has visited a casino knows it is easier to profit from speculation than it is to earn a profit through industry, particularly when it has been repeatedly demonstrated that speculation is a **"protected"** activity in this current era of **"moral hazard."** And while the runaway inflation in asset prices has benefited some investors, it has also underscored the fundamental flaw of every **ponzi scheme**, namely that a debt-financed speculation must perpetually accelerate or end in a spectacular wave of bankruptcy. That this reality has not been lost on the stabilizers is abundantly clear and is reflected in the chart by the **unprecedented expansion** of the Federal Reserve's balance sheet (gray area) from $1 trillion to $3 trillion in the aftermath of the collapse of the housing bubble and the onset of the Great Recession. It is this reality which has made it imperative for the stabilizers to maintain the boom in asset prices at all costs and which has convinced us that **Atlas cannot shrug**.

Figure 5



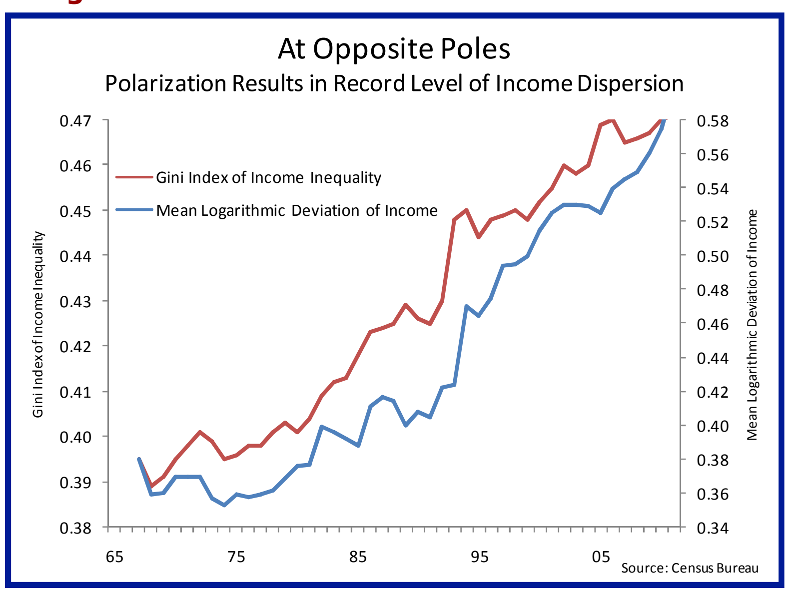
However, what is impermissible for Atlas is inevitable for the consumer. Contrary to the illusion that the economy is cyclically improving, we maintain that it is structurally impaired. Chief among them is the deteriorating condi-

Figure 6



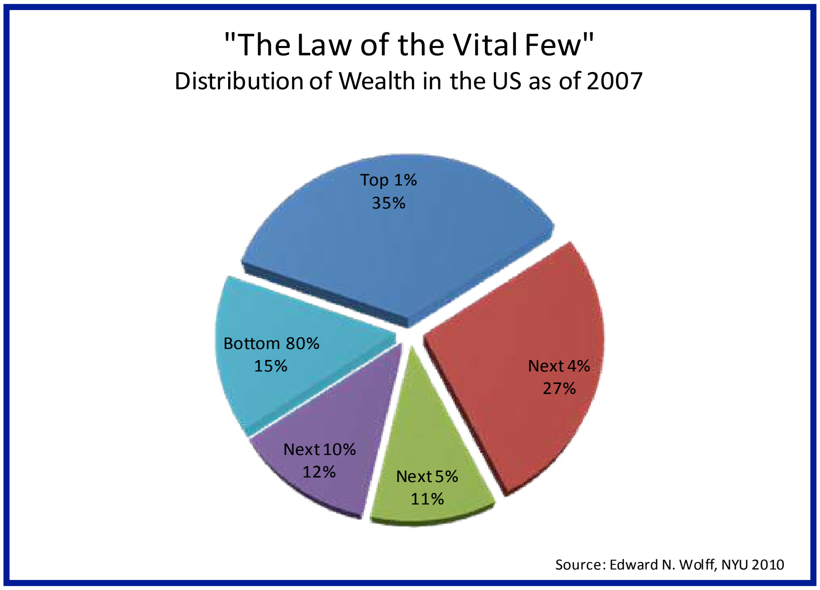
tion of the US consumer. In our Q3 2010 Market Review, we outlined the concept of the coming **"famine of income."** Looking at **Figure 6**, we can see that the famine may be upon us. Referring to the chart we can see that the modest recovery in real per capita personal income (blue line) which had began in October of 2009, has now rolled over, returning to its four year trend of declining real income. From its high in June of 2008, real per capita personal income has fallen **over 4 percent** and is currently at the same level it was in June of 2006, representing a **"famine" period of nearly 6 years** in which there has been no growth in real per capita income. However the picture becomes even worse when we **remove transfer payments** from the series. According to this measure, from its high in March of 2008, real per capita income less transfer payments (green line) has fallen by **8 percent**, or by twice as much as the first series. This measure is now at the same level as it was in June of 2004, **a "famine" period of over 7 years**. The red area on the chart represents the difference between the two series and highlights the **increasing dependence** of real personal income growth on the growth of transfer payments from the government.

Figure 7



The gradual deterioration in real or inflation-adjusted income has also revealed a record level of variance or dispersion in its distribution. This **"polarization of income"** is reflected in **Figure 7** by both the Gini Index of Income and the mean logarithmic deviation of income or MLD, both series are calculated by the Census Bureau. The Gini Income Index is a measure of statistical dispersion and as such it measures the income distribution of a country's residents. The number, which ranges between 0 and 1, helps to illustrate the gap between rich and poor, with 0 representing perfect equality of income and 1 representing perfect inequality of income, i.e., 100 percent of the country's income would be earned by one person. As such, the higher the index value, the greater the level of income inequality in a nation. Like the Gini Index, the MLD index is also a measure of inequality. The MLD has a value of 0 when every individual in society has the same income, and like the Gini Index, a higher index level indicates a higher level of income inequality. As we can see in **Figure 7**, both measures of income distribution are at record extremes, reflected an **increased concentration of income in fewer hands**. Income variance in the US is higher today than it was in both 1929 and 1987, both periods of economic and financial distress, and is nearly double that of any other "advanced" economy. These extreme readings strongly suggest a hollowing out of the middle class.

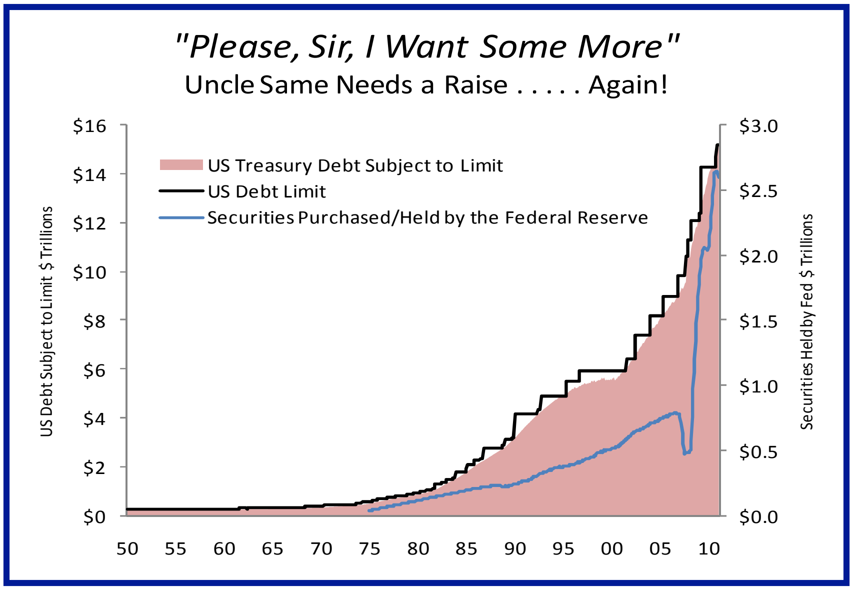
Figure 8



Unfortunately, it is not only the distribution of income that has been polarized, but the **distribution of wealth** as well. Recall we said that owing to the existence of monopolies, wealth is transferred by *force majeure*, from one pocket to another. Over time, this shows up in the form of an increasing concentration of wealth in fewer hands. Referring to **Figure 8**, we can see that according to economist Edward Wolff, as of 2007 the top **1 percent** of households in the US controlled **35 percent** of all wealth while the top **5 percent** controlled **62 percent** of the wealth. In fact the distribution closely approximates Italian economist Vilfredo Pareto's famous **80/20 rule** also known as the **"law of the vital few"** which held that in time, roughly 80 percent of the wealth or income would be controlled by 20 percent of the population. According to Professor Wolff, as of 2007 we are right on cue with the top 20 percent of households in the US controlling 85 percent of the wealth. As we have pointed out on previous occasions, it is not the total wealth of a nation, but its distribution that is of paramount importance. The greater the imbalance in a nation's distribution of wealth and income, the greater the instability of its society. Plutarch, the famous Roman historian once observed; ***"An imbalance between rich and poor is the oldest and most fatal element of all republics."*** Guess we know how it worked out for that "republic."

When the monopoly is isolated, it never fails to enrich the one granted the privilege under law. But when all seek the same privilege, **spoliation** is reduced to a system which offers the illusion that *everyone gains more from a market impoverished by all*. However, a funny thing happened on the way to the *Promised Land* of a Keynesian utopia. As we stated a year ago, the US and the West are at a crossroads. Faced with the growing realization that everyone cannot be enriched at the expense of everyone else, governments are grappling with how best to renege on promises that in fact, were never possible to keep. This has always been the calumny of socialism. To paraphrase Margaret Thatcher, there always comes a time when you run out of other people's money. And that time, even if it has not yet fully and finally arrived, can at least be *"seen from here"*, or more specifically in can be seen in **Figure 9**. Since September of 2008, total Treasury debt subject to limit has risen from $9.8 trillion to $15.2 trillion, an increase of **$5.4 trillion**, or **55 percent** in just three and one-half years. Given the dismal outlook for future fiscal deficits outlined earlier, the capacity of the "credit" of the US Treasury [read US dollar] to shoulder the potential coming demand tsunami, strains credulity. However the increase in the debt of sovereign nations, per se, is not the issue. They are merely a reflection of the disease. Unfortunately when the cure is worse than the disease, the addiction is likely fatal. So it is with drugs and alcohol. So it has always been with governments that have overdosed on unlimited paper money. This as we noted at the outset is the real **monetary sin of the west**.

Figure 9



Monetization of fiscal incontinence is the road to perdition and the stabilizers role in monetizing the profligacy of the US is a clear and present danger. As such we continue to believe that deflation is the fact facing the developed world, while (*hyper*) inflation through the debauchment of the currency is the fear. As such, the overriding theme will continue to be the forced deleveraging of the private sector pitted against the unprecedented efforts of the stabilizers to reflate. With monetary and fiscal policy committed to forestalling the needed correction of the massive malinvestments and economic distortions that remain, resources will continue to be misdirected, growth will be subpar and structural unemployment will remain stubbornly high. The banking crisis in Europe has taken them to the brink and the smell of sulfur is in the air. China, the workshop to the world, needs a consumer to keep its own bubble afloat, but the consumer to the world is spent. Ultimately, this is the paradox of our long-running faustian bargain with monetary inflationism, that gradualism in theory becomes perpetuity in practice. Yet as Robert Louis Stevenson wrote; ***"Everyone, sooner or later, sits down to a banquet of consequences."*** And while we do not foresee a formal default but rather a slow, irrevocable decline into economic mediocrity, others such as John Williams, have a more foreboding outlook. Writing in a recent special commentary on the **"coming Great Collapse: a hyperinflationary great depression"**, Mr. Williams says; *"The unfolding circumstance will encompass a complete loss in the purchasing power of the US dollar; a collapse in the normal stream of US commercial and economic activity; a collapse in the US financial system, as we know it; and a likely realignment of the US political environment."* Wow! To quote satirist Tom Lehrer; ***"But apart from that, Mrs. Lincoln, how was the play?"***