Redstone Advisors

Economic and Market Review

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"There is another evil I have seen under the sun. Kings and rulers make a grave mistake when they give great authority to foolish people and low positions to people of proven worth": "Folly is set in great dignity"

Ecclesiastes 10:5-6a NLT; 6a NKJV

"I'm the guy pushing a trillion-dollar infrastructure plan. With negative interest rates throughout the world, it's the greatest opportunity to rebuild everything. Ship yards, iron works, get them all jacked up. We're just going to throw it up against the wall and see if it sticks."

Steve Bannon, White House Chief Strategist for President Trump

"Now is the winter of our discontent, made glorious summer by this sun of York; And all the clouds that lour'd upon our house, in the deep bosom of the ocean buried" Usurping that first line of the opening soliloquy of Shakespeare's Richard III for our own editorial purposes, we are, by analogy, given to understand that at long last, our winter of economic distress has been transformed into a glorious summer of growth and all the clouds of doubt that had gathered threateningly above us, have been summarily banished. And to what do we owe this triumphant transformation of sentiment? Why merely to the ascendancy of Donald J. Trump to the presidency of the United States. Now we do not mean to impune either Mr. Trump or the Presidency of the US. Rather the point of the analogy lies not in the man nor in the office, but in the magical transformation of opinion regarding all things economic, due solely to the election of this *"sun of York*". Two weeks prior to the election of Mr. Trump, pundits stated categorically that a Trump presidency would devastate both stocks and the economy. Now, as stocks have soared in the aftermath of his election, those same apologists foresee a *glorious summer* replete with a renaissance of Reagan's Morning in America. As has been truly said, ***the Street is not rational; it is rationalizing***.

In our November publication entitled **The "Trump Tantrum"**, we said Trump's election was a **black swan event** for markets, which, *"after eight years of uninterrupted and unprecedented monetary stimulus"*, had been habituated to a single trade of ***'don't fight the Fed'***. With Mr. Trump's improbable win, traders and speculators were caught leaning one way, the unwinding of which led to a paradigm shift in speculative trading we dubbed the **Trump Tantrum**. However, as disruptive as this **trading recalibration** has been, the election of Mr. Trump **fundamentally changes nothing**. While we concede that his approach to governing will be unorthodox - billionaire businessmen as opposed to establishment politicos, twitter storms as opposed to press conferences, a personal style marked by confrontation rather than conciliation. Nevertheless, post-election of this *"sun of York*", the **secular forces of deflationary stagnation** are still *the* **fact** confronting policy makers. And while the emphasis in the battle against these forces will undoubtedly shift from a *monetary* to a *fiscal* front, was it after all these long years of deflationary winter, really *only fear that we had to fear*? To be sure, men of goodwill everywhere are pulling for President Trump and genuinely want to see America great again. But to believe that the long entrenched forces of decline can be painlessly overcome by an election and a credible promise to be profligate with fiscal spending speaks more to our hopes, than to reality. Addressing the plausibility of overruling reality by executive fiat, we lift a line by Sir Thomas More from 'A Man for all Seasons': *"Some men think the earth is round, other 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?"* To answer in the affirmative is ***to set folly in great dignity***.

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How does *folly* assume such prominence? In short, fallacy is bourn up to such lofty heights on the wings of ideas. Writing in 1936, John Keynes ended his book, '*The General Theory'* with the following pronouncement;

> *"The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly believed. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. Soon or late, it is ideas, not vested interests, which are dangerous for good or evil."*

Ironically, the *academic scribbler of a few years back* whose ***ideas*** now so completely dominate the economic policies of the *madmen in authority* around the world is none other than Lord Keynes himself. If we but turn to the current promulgations of the politicos or the academic pronouncements of the professional economists or the opinions of their journalistic lackeys, we encounter a never ending siren call for ***demand stimulus*** through either a **fiscal policy of deficit spending** or through a **monetary policy of interest rate manipulation and money printing**. Setting aside for the moment, the efficacy of the policy "*means*" being promoted, what of the desirability of the "*end*" selected? For the call to *stimulate demand* necessarily implies the *right to do so*, and by extension, claims a superiority by virtue of its necessity, over the free and uncoerced actions of a market economy. *"Necessity"*, we recall, *"is ever the plea of the tyrant."*

Enter Lord Keynes. His book, 'The General Theory', was written for the express purpose of establishing **demand deficiency as the *causa sine qua non* for recession** and by extension, to **agitate for government interventionism and inflationism**. In order to do this, Keynes first had to dispose of **Say's Law of Markets**. He did so masterfully with a twofold attack. First, he set up a **straw man** that made Say's Law an absurdity. This he achieved by reducing Say's Law to its most famous formulation: *"supply creates its own demand."* By this turn of a phrase, Keynes misrepresented Says' Law, implying that the law held that <u>whatever is produced will be consumed and therefore neither recession nor unemployment would be possible since every product offered on the market was guaranteed a buyer</u>. Next, Keynes presented a litany of reasons, including arguments for liquidity preference and the marginal propensity to consume, as to why demand deficiency, which Say's Law said was impossible, was the cause of recessions. By asserting that under classical theory, **protracted recessions were impossible**, and simultaneously establishing **demand failure as the proximate cause of a recession**, Keynes, by process of elimination, now offered a viable explanation for recessions. **Capitalism**, declared Keynes, **was in crisis**. It had been tried and found wanting. The miserly consumer, desirous of saving or hoarding, could withhold demand, dragging recession and unemployment in its wake. But be of good cheer, for 'The General Theory' brings good tidings of great joy to all people. The government would supply what was lacking. Scarcity would be banished, and a *brave new world* would open up. Writing in his book 'The Road to Serfdom', F.A. Hayek identifies the self-serving nature of Keynes' new idea; *"The fact that the 'fatal idea' which became Keynesian theory provided the politicians with tempting opportunities was probably even more important than the fashionable prejudices concerning scientific method that made it attractive to professional economists. It offered not only a cheap and quick method of removing a major source of real human suffering, but also a release from the most* *confining restrictions that had impeded their striving for popularity. Spending money and having budget deficits were suddenly represented as virtues. It was even argued persuasively that increased government expenditure was wholly meritorious, since it led to the utilization of hitherto unused resources, thus costing the community nothing and bringing it a net gain."* Appealing to those in authority, the coup was complete. Keynes *fatal idea* of **'something for nothing'**, surely the **greatest folly ever to be countenanced as wisdom**, had been inaugurated.

Now, on the eve of President Trump's inauguration, that same *'fatal idea'* which permeated the entire fabric of Keynes' long and elaborate theory has contracted, assumed the guise of a principle, and today finds voice in a single phrase – **deficient demand**. At the mere utterance of that phrase, not unlike the braying of the trumpet by King Nebuchadnezzar, all should reflexively accede to both the necessity as well as the efficacy of the **coming stimulus**. Count us among the trio who refuse to bow the knee, for we continue to deny the veracity of a theory of wealth based on *something for nothing*, while stubbornly insisting that the prescribed **solution** – *demand stimulus* - **remains the problem**. We have for years agitated against both the **injustice** as well as the **disutility** of the continuing policies of **interventionism** and **inflationism**, the results of which have been a massive *degree of disorder* in both the financial markets as well as the economy. The current *economic winter*, that, despite the election of President Trump, continues to hold sway over both the US and most western developed economies – a malaise we have characterized as a ***rolling or permanent recession*** consisting of persistent below-potential economic growth, intractable underemployment, exponential growth in debt, and a massive famine of income - is **structural** not cyclical. <u>It represents the cumulative distortive impact of over forty years of increasing intervention and monetary inflation</u>. By following the Keynesian prescription to fight the mythical monster of underconsumption, the stabilizers have brought about a **real intractable demand problem**. But it is not the one diagnosed by Keynes, but rather the one that Austrian and Scholastic theory predicted would be *caused* by Keynes: A state of continual instability, due to the accumulation of error and malinvestment, the perpetuation of which is pulling the economy into the morass of a long, slow decline into mediocrity. It is not simply that through a perpetual policy of interventionism, we have engaged in a massive campaign of borrowing from the future to fund today's alleged underconsumption, leaving large and growing burdens for the next generation, thus exemplifying Austrian economist Eugen von Böhm-Bawerk's observation; ***"Debt is future consumption denied."*** No it is rather, that by pursuing the **wrong end**, <u>perpetual prosperity through demand management</u>, we have caused the **discoordination of production** and the **displacement of income** on a massive scale, permanently diminishing the **pool of real wealth** available for future economic growth. This conundrum was clearly articulated by one 1930's writer as follows: *"The farmer has no money to buy the products of the factory because the factory worker has no money to buy the produce of the farmer because the factory is idle because the farmer has no money."* What he said.

While interventionism, the proximate cause of the **accumulation of economic error** and stagnation, can take on many forms, the most favored and the most insidious is **inflation through the corruption of money**. Unfortunately, there remains widespread confusion as to what inflation actually is. As used by most in the economics profession and the popular media, "inflation" is defined as an overall increase in prices, typically as measured by some price index such as CPI. However a potential increase in the general price level is only <u>*one*</u>

possible effect of inflation, **it is not inflation itself**. [A bubble in asset prices is equally an effect of inflation] No, inflation is, and will always and everywhere be, **an increase in the supply of money within an economy.** Juxtaposing *effect for cause* allows blame to be shifted from the banking cartel to "parasitic capitalists", while at the same time obscures the injustice of the swindle committed by the state or sovereign. Ironically, neither the cause nor the insidious effects of inflation were lost on the founder of "institutionalized inflation", Lord Keynes, who, writing prior to his conversion to the **flat earth society** in his 1919 publication, 'The Economic Consequences of Peace', attributed the "destructive peace" of the Versailles Treaty to the **pernicious inflation** it demanded: *"Lenin is said to have declared that the best way to destroy the Capitalist System was to* ***debauch the currency****. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some.*

That statement, made nearly 100 years ago by Keynes, while not original – the immorality of arbitrarily debasing the value of money (inflation) has been maintained since man first engaged in exchange – in our opinion, brooks no equal. Not unlike Greenspan's unrivaled 1968 defense of gold prior to his ascendency to the Chairmanship of the Fed, Keynes, prior to his coronation as titular head of the Keynesian Revolution, demonstrates an unparalleled grasp of what inflation is - *a debauchment of the currency* - how it is employed – *by a continuing process* – and what it achieves – *secret confiscation of wealth resulting in an arbitrary redistribution of wealth*. And what is equally clear, from the language employed Keynes condemns the practice for what it is: immoral. Here it is then, elegantly articulated in all its destructive capacity by a man, whose ideals today, wields unrivaled influence over such a large flock, yet so far from being reproached for the evil it is, incredulously we hail it as a virtue, a tonic, a stimulant to be employed at all times for our improvement. Are we not told daily by the stabilizers the world over, that the key to restoring economic growth is **reflation**? Talk about calling evil good. Mises correctly labeled the "semantic revolution" in economics as *by no means harmless. "To rob the public"*, Bastiat said, *"it is necessary to deceive them. To deceive them, it is necessary to persuade them they are being robbed for their own advantage."*

How is this inflationary swindle to be accomplished? Enter **"money magic"**. As part of his 'General Theory', Keynes postulated a theory of debt whereby **money is independent of wealth**. After all, no one wants to hear that when they spent money, they consumed goods. However, if debts can cancel out debts without the help of any existing goods to support the transaction, a new and beautiful world opens up before us. We can give up producing altogether. This is no exaggeration. It is merely the logical conclusion from Keynes theory of money as a closed system. (One only has to consider the current popularity for 'universal incomes') Fortunately, this to, had been anticipated many long years before. Swedish economist Knut Wicksell and Austrian economist Ludwig von Mises both wrote extensively on the effects of **interest rate manipulation on the discoordination of the caital structure**. Wicksell was the first to present the idea of the **natural rate of interest**, which he argued can be different from the prevailing **market rate of interest**. The natural rate is equal to the return on capital in an imaginary economy where real capital goods are loaned one for another without money. What is of paramount importance is to understand the inseparable link between money and economic goods. Money's sole purpose is to act as a representative of and a medium of exchange of, real capital goods, the pure exchange of which would, according to Wicksell, determine the natural rate of interest. Money, however paradoxical it may seem, is not wealth, it merely represents it. However when the banking cartel, through fractional reserve banking, loans money into existence not backed by savings/wealth ("money magic"), then that balance will be violated as the increase in the supply of outstanding money claims bidding for real capital goods will be disassociated from, and disproportionate to, the available supply of real capital goods. This problem of ***too many claims chasing too few goods*** misleads producers into thinking there are more real savings available than society actually wishes to save. Producers then make errors, producing the wrong mix of capital goods in relation to consumption goods, resulting in *"the displacement of the distribution of income and wealth.*

Having labored to establish the truth that the acceptance of Keynes fatal idea of intervention through inflation is to enshrine folly as wisdom, we now return to the theme of this "novel", namely that with the election of President Trump, hope notwithstanding, **nothing fundamentally has changed**. As we have already conceded, President Trump has clearly signaled a shift in emphasis from a sole reliance on monetary policy to include the addition of fiscal policy – a change in means – nevertheless, the same end is still being pursued - reflation through intervention in the economy and markets. To continue with our *Shakespearean* motif, surely *"a rose by any other name . . . ?"* Despite the election of President Trump, the pursuit of the same end, changing only the means is unlikely to alter the outcome. After more than forty years of continuing intervention, too much wealth remains impaired. The malinvestments have not been cleared. Resources have not been reallocated. The inequality of wealth and income has risen to all-time extremes. Financial activity has displaced the production of real things as the driver of economic activity. Asset prices are disproportionately determined by the stabilizers. Risk has been massively mispriced. Financial speculation dominates financial market activity. This, we submit, is the "wisdom" of planning: the arbitrary selection of winners and losers, benefiting the privileged few and harming the many who have been "left behind." And despite his excellent intentions, the policies pronounced by President Trump do not *foreshadow any real change*. In his beloved story, 'A Christmas Carol', Dickens recounts a tale of redemption, and redemption, by definition involves a change in direction. For surely *"if men's courses be departed from, the ends will change."* And change they must if we are to alter the shadows that continue to beset us as a nation and *"sponge away the writing"* that is inexorably writ large on our national ledger.

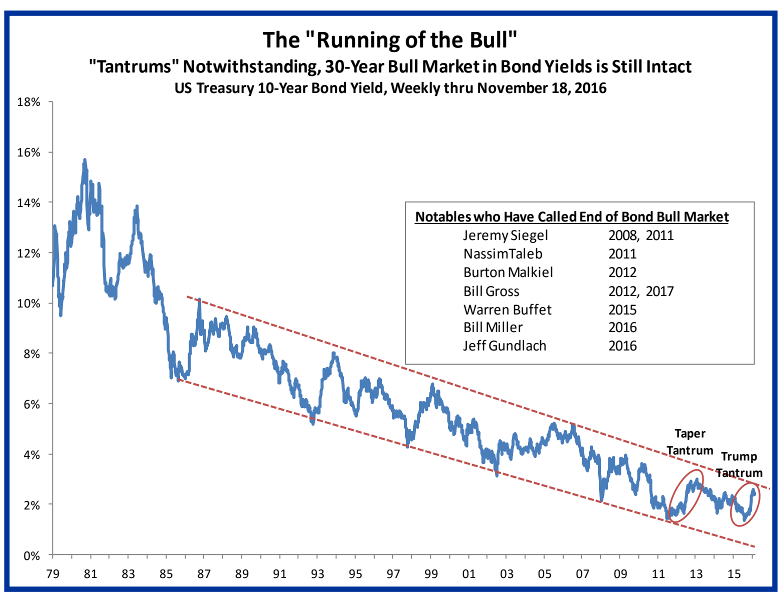
Those "courses" thus far proposed by President Trump, show no signs of a turning. From what has been made public, President Trump's plan appears to be precisely what Keynes would have prescribed. Replete with promises to cut taxes and underwrite a massive increase in spending, the projected budget deficits - already set to accelerate due to the aging of America and the rising costs of Social Security and Medicare - appear likely *to grow to the sky*. While clearly it is far too early to make anything more than an educated guess as to which proposals will be implemented and their resulting impact on either the deficit or economy, it is reasonable to conclude that President Trump has not demonstrated, by word or by deed, any intention *of taking the road less traveled* and actually reducing the level of intervention or inflation. Rather, continuing down the *broad road*, the President appears to be preoccupied with the old problem of **deficient demand** and the **fatal idea** that government should stand in the gap. Yes we are aware of his proposals to reduce government regulations, particularly in the energy and the environmental sectors. To the extent that this is achieved, it should benefit those industries affected. But the President is also rattling his saber regarding trade and immigration, with proposed changes in these sectors, while aimed at putting America First, likely to harm some. And then there is always the law of **unintended consequences**, what Andrew Gelman says happens *"when a simple system tries to regulate a complex system."*The point is that while President Trump's policies may, at the margin, change some of the names of the favored few, nevertheless the system of picking "winners", and by non-selection, "losers", thus conferring an unjust advantage on one party over another, is set to continue without interruption. Writing in 'The American Empire' back in 1952, Garet Garrett underscores the reality of the challenge facing both President Trump and our nation: *"When the economy has for a long time been moving by jet propulsion, the higher the faster, on the fuel of perpetual war and planned inflation, time comes when you have to choose whether to go on and on and dissolve in the stratosphere, or decelerate. But deceleration will cause a terrific shock. Who will say, "Now!" Who is willing to face the grim and dangerous realities of deflation and depression? No leader has yet appeared with the courage to make them choose."*

Absent courage, deflation still remains the fact informing all policy decisions. In this again, nothing has changed. To disabuse Say's Law; *inflation creates its' own deflation*. In a credit economy that has disassociated the creation of money (credit) from the production of wealth ("money magic"), a sustained contraction in credit creation threatens the solvency of the banking cartel. All money in our fiat credit economy is debt, as all money is "loaned" into existence through the fractional reserve banking system. As such, <u>the supply of credit is determined by the demand for credit</u>. As banks profit from the expansion of credit via the perpetual compounding of interest, they also have a vested business interest in perpetuating the credit inflation. This vested interest in sustaining the credit inflation is expressed through the manipulation of the market rate of interest versus the natural rate postulated by Wicksell. However, as noted earlier, the inflation of credit results in malinvestments and the displacement of wealth, and when not corrected, the compounding of error. Ultimately a day arrives when there is not enough **real capital** to complete all of the projects pursued as a result of the credit inflation. Uncompleted projects translate into losses, the default of which initiates a **credit deflation**, as <u>only wealth can cancel a debt</u>. Deferring to American economist Irving Fisher; *"A credit inflation that creates claims that masquerade as money is prone to deflation since the wealth needed to liquidate the credit is in short supply relative to outstanding credit claims."* Through the Keynesian policy of perpetual credit inflation to eliminate the blight of **deficient demand**, we have labored to put in place a massive level of debt, the **prospective deflation of which**, continues to threaten the solvency of the banking cartel, and by extension both the economy and markets. *Give a man a gun and he can rob a bank. Give a man a bank and he can rob the world*.

Despite the absence of any real change in the long-running policy of intervention and inflation, the election of Mr. Trump introduces some new risks into the equation. These include **increased market volatility** due to the new President's more abrupt and impulsive "style" of governance. Based on recent **"twitter storms"**, it is difficult to predict which company or industry practice will attract his attention next. However of more particular interest, there have been indications of a desire to increase **political control** over the Federal Reserve. This includes the recent passage of Sen. Rand Paul's **Federal Reserve Transparency Act**, better known as **"Audit the**

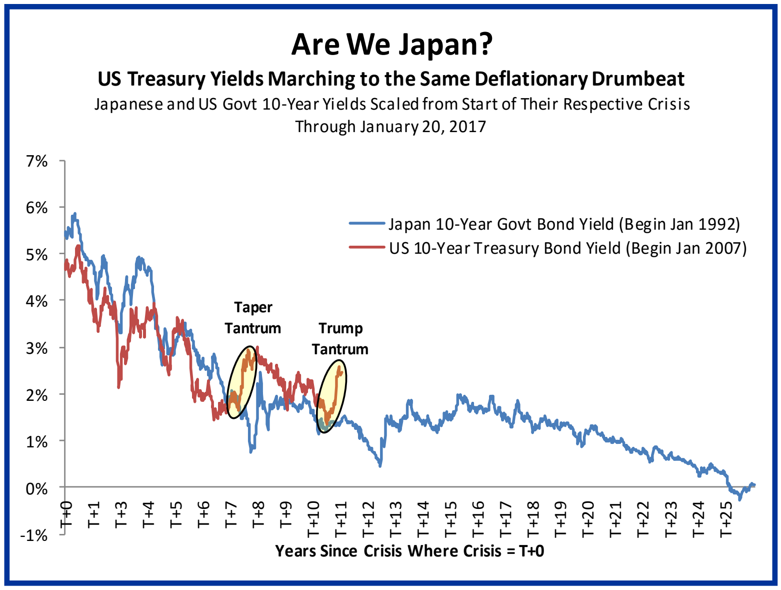
Fed Bill", legislation demanding greater accountability by the Fed, and a bill which President Trump has said he would likely sign. Additionally, there are currently two vacant seats on the Federal Open Market Committee which President Trump can fill as soon as he takes office. While not sufficient to shift the balance of power, there are credible scenarios whereby he could nominate up to six appointments by the end of his first two years in office, a number sufficient to bring about *the winds of change*. Given the **differing inflationary incentives** between the **political class** and the **banking class**, a marked move toward the politicization of the Federal Reserve and away from the banking cartel, could, especially during a crisis, lead to the pursuit of a monetary policy which risks **open price inflation** through the direct monetization of fiscal deficits in contrast to the long running policy of the **hidden inflation** of **money magic**. In fact, such a policy was recently proposed by Adair Turner, Chairman of the Institute for New Economic Thinking. In his paper entitled '**The Case for Monetary Finance**', he openly advocates intentionally running large fiscal deficits financed by a permanent increase in the monetary base, i.e., monetization, a practice he refers to as **"helicopter money"**. Eerily reminiscent of the pronouncements made by former Federal Reserve Chairman Bernanke, Mr. Turner insists; *"Monetary finance of increased fiscal deficit will always stimulate nominal demand."* Further, Mr. Turner advocates its' use both, in the face of a post-crisis debt overhang, or on a **continuous basis** when faced with **secular stagnation**. Clearly such an amalgamation of fiscal and monetary policy would exacerbate the risks to the stability of the monetary system.

What shall we say then about the impact of the election of Mr. Trump on **interest rates**? As we have repeatedly stated, in our opinion, **fundamentally nothing has changed with respect to our view of the trajectory of the economy**. The forces of secular stagnation – through past excesses of perpetual intervention and inflation - are still conspiring with the headwinds of a massive overhang of debt, deteriorating demographics, and the financialization and the globalization of the economy to restrain economic growth. This, we maintain, is our continuing legacy of *setting folly in great dignity*. The search for the philosophers' stone, capable of turning deflationary water into reflationary wine, continues. Nevertheless, interest rates rose sharply in the wake of the **Trump Tantrum** as the banking cartel's long running policy goal of **lower-for-longer interest rates** slammed into the reality of the **"black swan"** that was the election of President Trump and his promise to pursue an *open price inflation through fiscal deficits*. Over the course of the past eight years, the stabilizers have taken unprecedented policy steps to arbitrarily keep interest rates near the zero bound. Writing in '**The Trump Tantrum**', we said; *"Borne out by the idiom 'desperate times*



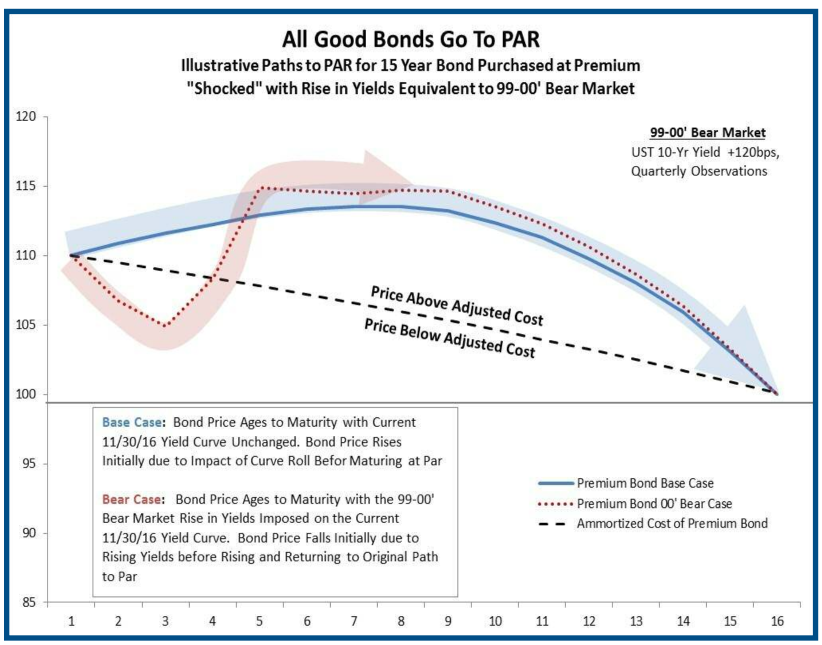
demand desperate measures', nowhere is the severity of our economic distress more clearly revealed than in the exigency of the actions taken by monetary policy makers." As such, the market's initial reaction to the possibility that a monetary policy driven by the exclusive interests of the banking cartel, might be subjugated to those of the political class – a reaction we labeled "**The Trump Tantrum**" – was predictable. Markets have a well established tendency to **"rush to judgment"** during periods of major policy shifts. However, given that the economic environment post-election remains virtually unchanged, it remains our judgment that the secular declining trend in long-term interest rates remains equally unchanged. (**The Running of the Bull** chart)

Classical economics correctly posits a real causal relationship between economic growth (savings and investment) and long-term interest rates. This has been aptly borne out by **Japan's Lost Decades** of economic growth and resultant secular decline in interest rates. And while of a certainty, only principles – not correlation – can establish causation, it can nevertheless, illustrate it. Referring to the chart '**Are We Japan?**', we can see that when indexed to the start of each country's respective crisis, long-term interest rates in the US have been roughly following the same deflationary path as Japan. And while the two series did diverge in late 2013 due to the "**Taper Tantrum"**, US yields subsequently returned to trend, in confirmation that fundamentally, nothing had changed. In the same way, despite the recent divergence of US yields due to the **"Trump Tantrum"**, we expect US yields to return to the same long-term downward trend, confirming again that **we are still marching to the same deflationary drumbeat**.



However, due to the wholesale acceptance of Keynes **'fatal idea'**, that relationship posited by classical and Austrian economics has been effectively suborned by the heavy handed intervention of the stabilizers. Ultimately we believe that a **sustained rise in interest rates** would be **self-limiting**, as the rise in yields would negatively impact both economic activity (primarily through lending), as well as the valuation of asset prices through higher discount rates, increasing the probability of a recession and/or a severe market correction. Given the recent **Tantrum** in interest rates due to the **collision of two worlds** – banking interests and political interests – the claim of the 'rate-rising' crowd that interest rates "will surely rise now" has reached a feverish pitch. And while we continue to believe that in so far as the *new policies* of the *new administration*, continues to pursue *old ends*, the outcome – a secular decline in both growth and interest rates - will remain unchanged, we are nevertheless, mindful that any such determination if fraught with **uncertainty**. *"Doubt"*, Voltaire thundered, *"may be an unpleasant condition, but certainty is absurd."* In this era of **unstable stability**, all assets are, to one degree or another, at risk from any number of random snowflakes which could potentially trigger a deflationary avalanche; the dollar, China and Europe just to name a few. Nevertheless, some assets are better suited than others to weather such a storm.

Bonds are legally enforceable contractual obligations to pay; stocks are not. Absent credit risk, with the passage of time, that most unique feature of bonds, the maturity date, mitigates and ultimately eliminates market risk as **every good bond always goes to par**. As such, the investor will have his capital returned, with, at a minimum, a **guaranteed income return**. Stocks offer no such guarantee. The chart **'All Good Bonds Go To PAR'** visually illustrates this "guarantee" over an investment horizon. The chart depicts two possible **price paths to par or maturity**, for a single 15 year premium bond, priced at the current 2017 market yields. The **blue line**, which we refer to as the **base case**, illustrates the price path to par under the hypothetical condition of **no change in interest rates** over the entire 15 year life of the bond. Obviously, this is not going to happen. Nevertheless it illustrates two important attributes of a bond. First, that absent a change in yields, an **upward sloping yield** curve will cause the **price of the bond to rise at first as it rolls to maturity**. This is referred to as *"rolling down the yield curve"* and simply reflects the increase in price that results from a bond with a **fixed purchase yield**, being continually repriced at **successively lower yields**. Second, that absent a default, **the bond will always arrive safely at par**. The **red line** denoted the **bear case**, illustrates the same price path with the **99-00' bear market rise in yields** superimposed on the current yield structure. This illustrates a third attribute. While yields are rising, the price of the bond falls, however, after the rise in yields has subsided, the bond returns to its original path to par. Importantly, the **black dotted line** denotes the falling adjusted price of the bond as it is amortized to par, illustrating that the price of the bond returns to a gain position (**red line** above **black line**) even before returning to the original path to par. (**blue line**) Obviously, while interest rates are rising (bear market) the price is adversely affected, and **a sale of the bond** during this period would result in a realized loss. However, **absent a decision to sell**, the bond will return to its original glide path (**blue line**) and return the investors original capital with interest. Benjamin Graham long ago held that the proper definition of an investment was; *"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."* In our opinion, given this era of heightened risk when preservation of capital should be a primary goal, high quality bonds continue to meet that definition.



While we believe that the long-running trend in the decline of interest rates remains intact (**The Running of the Bull** chart), we also hasten to add that attempts to **"predict"** short-term movements in interest rates is a **fool's errand**. If you doubt this, one need only consult prior interest rate forecasts by the avowed experts. According to research by Bianco Research, since the **monthly** Bloomberg Survey of Economists began in December of 2002, the consensus has **predicted interest rates would rise 96 percent of the time**. In other words, month by month, year by year, the experts have always predicted that interest rates will rise and bond prices will fall. To listen to such "experts", there is apparently no good time to invest in bonds. Talk about a denigrated asset class. And what of the accuracy of those predictions? They were "directionally correct" 51 percent of the time. That is the equivalent of a **coin toss**. Addressing the choir, economist John Kenneth Galbraith justly concludes; *"The only function of economic forecasting is to make astrology look respectable."* However, we do not need to *read a prospective clients' palm* to know with certainty, that given the aforementioned unique properties of bonds, it is always an appropriate time to invest in high quality bonds as part of a **capital preservation strategy**. This is particularly true for investors in tax-exempt municipal bonds where the government guarantees a nearly 40 percent boost in after-tax return for investors in the top marginal income tax bracket. And as already demonstrated, absent credit risk, all principal invested will be returned at par plus interest. For clients, existing or prospective, with cash to invest, the current back-up in market yields due to the **"Trump Tantrum"** is offering an exceptional opportunity to put money into high quality taxable and tax-exempt bonds and lock-in higher nominal purchase yields. When combined with an active strategy of **duration targeting** - a rebalancing strategy to keep duration constant over the investment horizon - <u>original purchase yields become the primary determinative of the horizon return</u>.

Writing to King's College Cambridge many years ago, Keynes observed; *"Investing is an activity of forecasting the yield* (return) *over the life of the asset; speculation is the activity of forecasting the psychology of the market."* Economics, as we have often repeated, is the "*science*" of human action - lite on the science. At its core the *study* of economics must be primarily concerned with the nexus of human action, human choice. We live in a world of uncertainty, and what is uncertain is by definition, both unknowable and non-quantifiable. As such, the act of *choosing* amongst uncertainty by emotive and oft irrational, albeit self-interested human beings, is not well explained by probability distributions or statistical correlations. For this reason, economics is not, as it is so often portrayed and practiced by today's *New Economists*, a quantitative discipline governed by exacting and unrelenting laws like physics. Rather what can be known are the **universals**, the **principles**, which can, when correctly identified, form a worldview for the evaluation of not simply the utility, but also the fitness of the *means* chosen to achieve a particular end. *"Economics"*, as Mises stated, *"can answer the question whether a definite policy is able to attain the ends aimed at. But of course, this prediction can only be qualitative."* And so at long last, we return to Master More's question regarding the proposed **"wax nose"** of reality; can we, by fiat, rightly predict the future by making it. To this we stubbornly insist that **the earth is not flat**, and as Punxsutawney Phil has seen his shadow, winter will remain.