The Keynesian Depression

John Mauldin | February, 22, 2013

In today's *Outside the Box*, Scott Minerd, chief investment officer of Guggenheim Funds, regales us with the not-always-happy history of Keynesian economics – we did what he said when we had to, but not always when we should have. Shoving fiscal and monetary stimulus down the throat of a recession is well and good, but how about the part where we're supposed to be fiscally conservative during boom times? "What, raise taxes? No thank you!"

The upshot, as Minerd reminds us, is that "As a result of the constant fiscal support without the tax increases, businesses and households became comfortable operating with continuously higher leverage ratios. The conventional wisdom was that this government backstop could never be exhausted." Today we are testing that premise to the limit, and not only in the US.

Keynes forged his ideas in the fires of the Great Depression, but his disciples have, as Minerd wryly notes, "carried his views much further than could have been imagined during the period in which the master lived." Consequently, the downturn we now struggle to escape from is very different from the one that plagued the world of the 1930s. The key difference, Minerd tells us, is that:

> … for the first time since the 1930s, we have had severe asset deflation (declining real prices) in the face of relative price stability. Periods of asset deflation occurred between the 1960s and 1990s, but nominal prices were supported by rising inflation levels…. This protected asset-based lenders from severe losses resulting from declining nominal prices.
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> During the 2008 crisis, inflation levels were close to zero and unable to offset falling real asset values to stabilize nominal prices. This caused a debt deflation spiral to take hold as nominal prices fell. In contrast to the Great Depression, policymakers took extreme measures in 2008 to prevent a total collapse of the financial system and head off a deflationary spiral like that experienced in the 1930s. These policies included sharply increasing the money supply and engaging in an unprecedented amount of deficit spending.

To say the least. And all the easing and deficit spending worked to stave off financial disaster – up to a point. The problem is, we have just about reached that point – the point where, as Rogoff and Reinhart have so firmly instructed us, things turn out not to be that different after all. So let's jump into Minerd's take on the big picture, and see what he thinks the implications are for our investments.

But first, let me reveal that I find myself in Palm Springs this morning, getting ready to take a few hours off and embarrass myself with friends at the Indian Wells Golf Resort. Greg Weldon was on the plane last night (at 6'10", he has to be the tallest analyst in the writing game), and he told me to bring my "A" game to the golf course, as we'd be playing together. I just laughed and said I didn't even have an "X" game. I think if I shoot anything close to 120, I will just declare victory and walk to the clubhouse with a smirk. Big difference from my attitude in the "old days," when I had time (and a back) to play. Bottom line: It's a great course and a beautiful day, and I don't make my living with a golf club in my hand. Greg, on the other hand, brings the same intensity to everything he does, whether it's trading or golf or the World Series of Poker. I will watch him exult and curse, maybe on the same hole. I only get intense these days when I write. *C'est la guerre*.

Grant Williams is in town, and we will be spending a lot of time the next few days comparing notes and doing some videos for our readers (that would be you, and you'll see them shortly). As everyone knows, I am a huge Grant Williams fanboy. It helps that he is also one of the nicest human beings anywhere.

I am speaking at the Cambridge House Natural Resources Conference here. Rick Rule of Sprott is coming in, and we will have dinner. My Mauldin Economics team partners are also in town, to help with the video and plan out some great new letters. I am really excited about the directions we are taking. They are opening up whole new ways for me to help you.

Oddly, it is colder here in Palm Springs than it was back in Dallas, but pleasant all the same. Have a great weekend.

Your wondering where his ball went analyst,

John Mauldin, Editor
Outside the Box

(The **real** editor's note: John apparently finished this on his iPad at the third hole. He was probably not kidding about having lost his ball.)

The Keynesian Depression

A Premonition From a Halcyon Era

By Scott Minerd, Chief Investment Officer, Guggenheim Funds

In 1968, America was literally over the moon. Apollo 7 had just made the first manned lunar orbit and the nation would soon witness Neil Armstrong's moonwalk. The United States was winning the war in Southeast Asia and the Great Society was on the verge of eliminating poverty. I remember my father taking me to the Buick dealership that summer in Connellsville, Pennsylvania, where he bought a 1969 Electra. As we drove home I asked him why we had bought the 1969 model when we had the 1968 one, which seemed equally good.

"That's just what you do now," my father said, "Every year you go and get a new car." "Wouldn't it be better," I asked as a precocious nine year-old, "if we saved our money in case a depression happened?" I will never forget my father's reply: "Son, the next depression will be completely different from the one that I knew as a boy. In that depression, virtually nobody had any money so if you had even a little, you could buy nearly anything. In the next depression, everyone will have plenty of money but it won't buy much of anything." Little did I realize, then, how prescient my father would prove to be.

Five years have passed since the beginning of the Great Recession. Growth is slow, joblessness is elevated, and the knock-on effects continue to drag down the global economy. The panic in financial markets in 2008 that caused a systemic crisis and a sharp fall in asset values still weighs on markets around the world. The primary difference between today and the 1930s, when the U.S. experienced its last systemic crisis, has been the response by policymakers. Having the benefit of hindsight, policymakers acted swiftly to avoid the mistakes of the Great Depression by applying Keynesian solutions. Today, I believe we are in the midst of the Keynesian Depression that my father predicted. Like the last depression, we are likely to live with the unintended consequences of the policy response for years to come.

This Depression is Brought to You By...

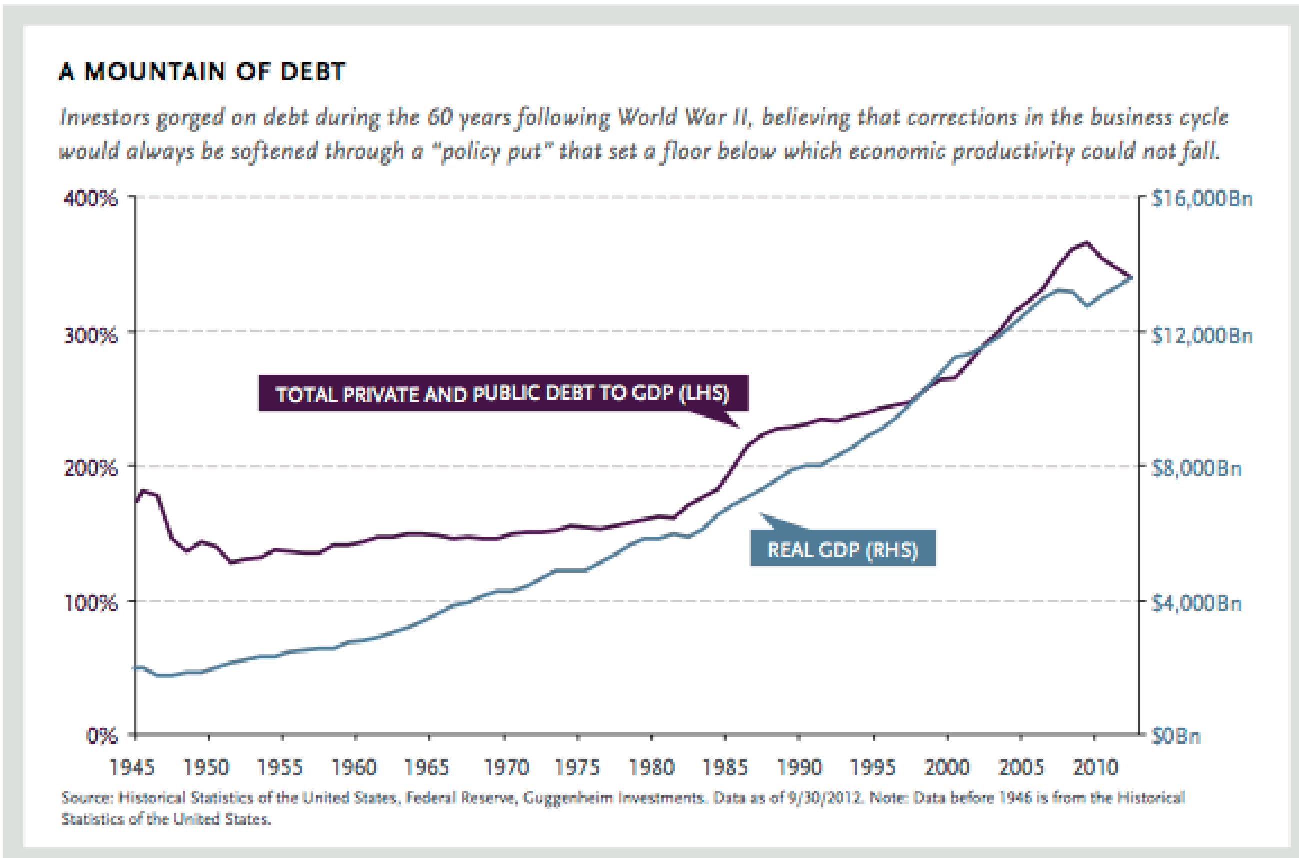
John Maynard Keynes (1883—1946) was a British economist and the chief architect of contemporary macroeconomic theory. In the 1930s, he overturned classical economics with his monumental General Theory of Employment, Interest and Money, a book that, among other things, sought to explain the Great Depression and made prescriptions on how to escape it and avoid future economic catastrophes. Lord Keynes, a Cambridge- educated statistician by training, held various cabinet positions in the British government, was the U.K.'s representative at the 1944 Bretton Woods conference and, along with Milton Friedman, is recognized as the most influential economic thinker of the 20th century.

Keynes believed that classical economic theory, which focused on the long-run was a misleading guide for policymakers. He famously quipped that, "in the long run we're all dead." His view was that aggregate demand, not the classical theory of supply and demand, determines economic output. He also believed that governments could positively intervene in markets and use deficit spending to smooth out business cycles, thereby lessening the pain of economic contractions. Keynes called this "priming the pump."

On Your Mark, Get Set, Spend

Since the Second World War, policymakers concerned with both fiscal and monetary policy have opportunistically followed certain Keynesian principles, particularly using government spending as a stabilizer during periods of economic contraction. In 1968, steady economic growth and low inflation had led optimists to declare that the business cycle was dead. When President Nixon ended gold convertibility of the dollar in 1971 he justified it by declaring that he was a Keynesian. Even Milton Friedman, founder of the monetary school of economics, told Time magazine that from a methodological standpoint, "We're all Keynesians now."

In dampening each successive downturn, authorities accumulated increasingly larger deficits and brought about a debt supercycle that lasted in excess of half a century. The complementary aspect of Keynes' guidance on deficit spending – raising taxes during upswings – was rarely followed because of its political unpopularity. As a result of the constant fiscal support without the tax increases, businesses and households became comfortable operating with continuously higher leverage ratios. The conventional wisdom was that this government backstop could never be exhausted.



The calamity in the financial system in 2007 and 2008 signaled the beginning of the unraveling of the global debt supercycle. The Keynesian model dictated that the best way to fix the problem was to run large deficits and increase the money supply. Keynes had based his prescriptions for this type of action on the early mismanagement of the Great Depression which he felt had prolonged the losses and hardship during that time. As is the case with most groundbreaking philosophies, Keynes' disciples carried his views much further than could have been imagined during the period in which the master lived.

The Depression My Father Knew

Keynes viewed governments' attempts at belt-tightening during the Great Depression as ill-timed. Although President Roosevelt invested in massive public works projects under the New Deal starting in 1933, almost four years into the crisis, the U.S. government maintained a policy of attempting to balance the budget as the depression raged on. Keynes's response was: "The boom, not the slump, is the right time for austerity at the

Treasury." The other problem, according to Keynes, was that the Federal Reserve's attempts to lower real interest rates and inject cash into the system were too modest and too late to avoid what he referred to as a liquidity trap, leading people to hoard cash instead of consuming.

To illustrate the dynamics of the liquidity trap Keynes cleverly invoked the analogy of "pushing on a string." He said that at some point, attempting to stimulate demand by easing credit conditions is like trying to push a string that is tied to an object you want to move. Whereas you can easily pull something toward you by the string to which an object is tied (raising interest rates to slow growth), attempting to carry out the opposite by reversed means (lowering interest rates to try to induce lending to otherwise unwilling borrowers) is not always successful. This is especially true when the rate of inflation becomes so low that it becomes impossible to set interest rates below it.

This Time It's Different

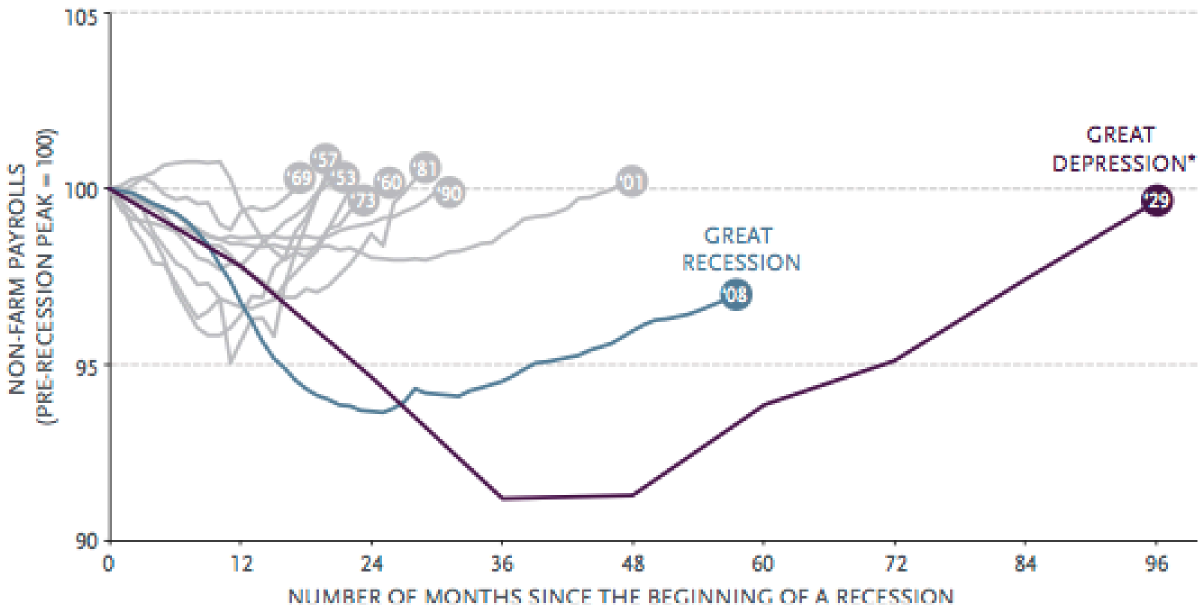
What sets the current downturn apart from any other since the Great Depression is that, for the first time since the 1930s, we have had severe asset deflation (declining real prices) in the face of relative price stability. Periods of asset deflation occurred between the 1960s and 1990s, but nominal prices were supported by rising inflation levels. Against the backdrop of a rising price level, nominal asset prices remained stable or continued to increase as real asset prices declined. This protected asset-based lenders from severe losses resulting from declining nominal prices.

During the 2008 crisis, inflation levels were close to zero and unable to offset falling real asset values to stabilize nominal prices. This caused a debt deflation spiral to take hold as nominal prices fell. In contrast to the Great Depression, policymakers took extreme measures in 2008 to prevent a total collapse of the financial system and head off a deflationary spiral like that experienced in the 1930s. These policies included sharply increasing the money supply and engaging in an unprecedented amount of deficit spending.

In many ways the swift policy action proved highly effective. Instead of the 25 percent unemployment seen in the 1930s, joblessness reached only 10 percent. While unemployment now stands at roughly eight percent, if one uses the labor force participation rate from 2008, the level is still higher than 11 percent. Although there was a 3.5 percent decline in the price level between July and December of 2008, policymakers immediately tackled and reversed the deflationary spiral. This compares with the Great Depression, when between 1929 and 1933 the general price level declined by 25 percent.

THE GREAT MALAISE

The Federal Reserve, empowered by a compliant Congress and White House, averted the complete ruination of the financial sector that could have occurred in 2008. The world did not enter another Great Depression. Instead it entered, and remains in, a Keynesian Depression.



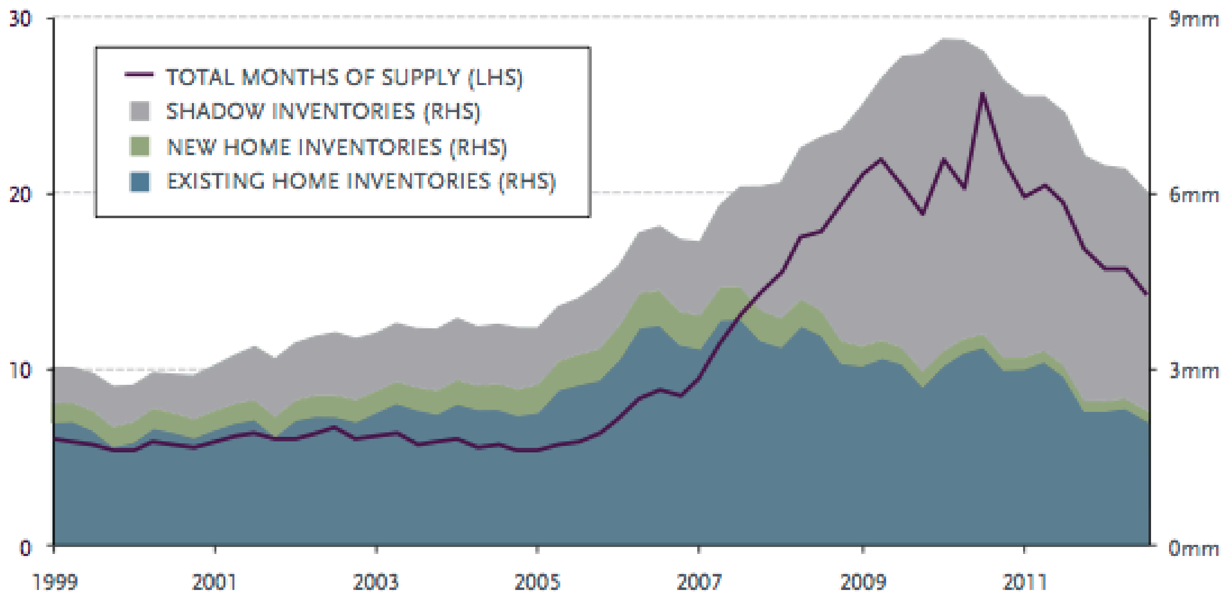
Source: Historical Statistics of the United States, Bureau of Labor Statistics, Bloomberg, Guggenheim Investments. Data as of 10/31/2012.
*Note: The payroll in Great Depression era has been adjusted for the change in nonfarm population.

The Aftermath

Though some may be cheered by the relative policy successes this time around, at the current trajectory it will still take almost as long for total employment to fully recover as it did in the 1930s. While job loss was not as severe this time, the recovery in job creation has been much slower. Although nominal and real gross domestic production have returned to new highs on a per capita basis, we are still below 2007 levels. In the same way the Great Depression and the depressions before it lasted eight to 10 years, we will likely continue to see constrained economic growth until 2015-2016 (roughly nine years after U.S. home prices began to slide). Only then will the excess inventory in the real estate market be absorbed, allowing the plumbing of the financial system to function, and supporting an increase in the economic growth rate.

HOME GAME

The excess inventory in the housing market is an important factor upon which the potential for the United States' economic recovery hinges. Housing cycles typically unfold over an 18-year period, with bull markets often lasting somewhat longer than half of that time.



Source: Bloomberg, Guggenheim Investments. Data as of 3Q2012.

At what cost did we attain this "success"? Like any strong medicine, the policies pursued since 2008 have had, and are continuing to have, unintended side effects. The most glaring feature of today's global landscape is that governments around the world have exhausted their capacity to borrow money and have turned to their central banks to provide unlimited credit. In the United States, it has taken an average annual deficit of $1.2 trillion and multiple rounds of quantitative easing just to keep the economy growing at a subpar rate since 2009.

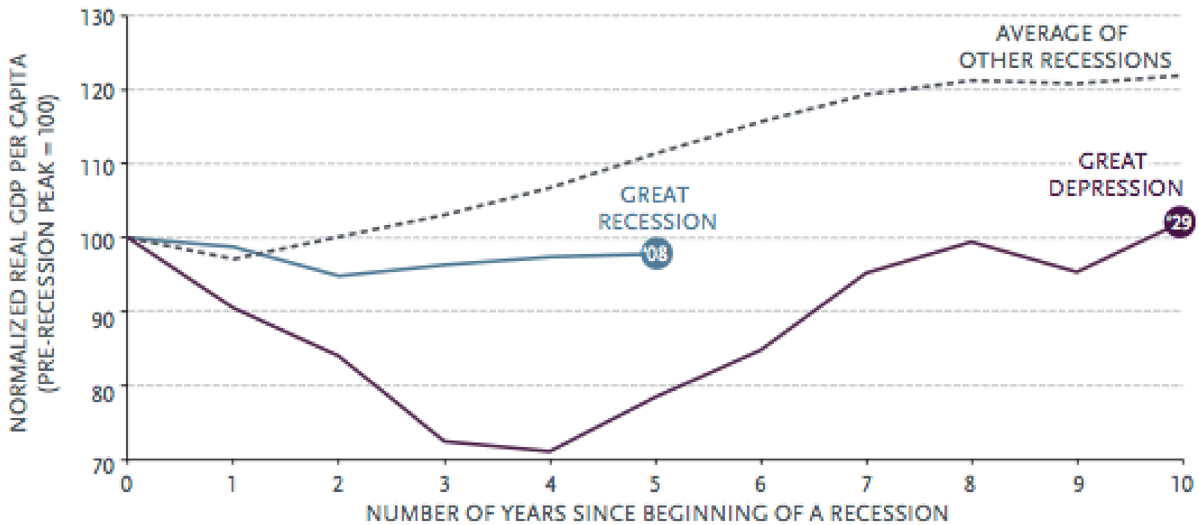
In their 2009 book, *This Time It's Different: Eight Centuries of Financial Folly,* the economists Carmen Reinhart and Kenneth Rogoff catalogue more than 250 financial crises and conclude that the U.S. cannot reasonably expect to circumvent the outcome that has befallen all overleveraged nations. In the authors' words:

> ...Highly leveraged economies, particularly those in which continual rollover of short-term debt is sustained only by confidence in relatively illiquid underlying assets, seldom survive forever, particularly if leverage continues to grow unchecked.

Sovereign powers saddled with debt loads as large as those of the U.S., Europe, and Japan today are jeopardizing their long-term economic wellbeing.

IT TAKES LONGER THAN YOU MIGHT THINK

Recoveries from recessions accompanied by crises in the financial sector tend to be slower and are associated with weak domestic demand and tight credit conditions. A 2009 International Monetary Fund study analyzed 122 recessions in 17 advanced economies since 1960 and concluded that recessions associated with financial crises have been more severe and lasted longer than recessions associated with other shocks.



Source: Haver Analytics, Guggenheim Investments. Data as of 3Q2012. Note: The average of other recessions include recessions covers all recessions happening between 1929 and 2007.

In an October 2012 whitepaper, Reinhart and Rogoff re-emphasized their findings that the U.S. cannot expect to quickly emerge from what occurred in 2008. They point out that 2008 was the first systemic crisis in the U.S. since the 1930s so the consequences have been much more significant than fall-outs from normal recessions.

What Comes Next?

The most important question for investors concerns how public sector debt levels, which have risen exponentially over the past half-decade, will ultimately be discharged. As Reinhart and Rogoff discuss, there are three options to reducing debt levels. The first is restructuring, also known as default. For obvious reasons this is painful and typically avoided except under the most dire circumstances. Governments can also pursue structural reform, which in today's case would mean greater austerity. Implementation of this would stand in stark opposition to Keynes's recommendation that the fiscal and monetary spigots be kept open during hard times. Although tightening is arguably the best long-term path, it appears unlikely that it will be the primary policy of choice in the near future. The third method, toward which I see global central bankers drifting, is to keep interest rates artificially low and permit increasing levels of inflation in the economy.

Pushing down the cost of borrowing and allowing the price level to rise is known as financial repression. The real value of debtors' obligations is reduced by financially repressive policies. Keynes warned of the dangers of inflation in his early work, The Economic Consequences of the Peace, which presciently criticized the harshness of the Treaty of Versailles:

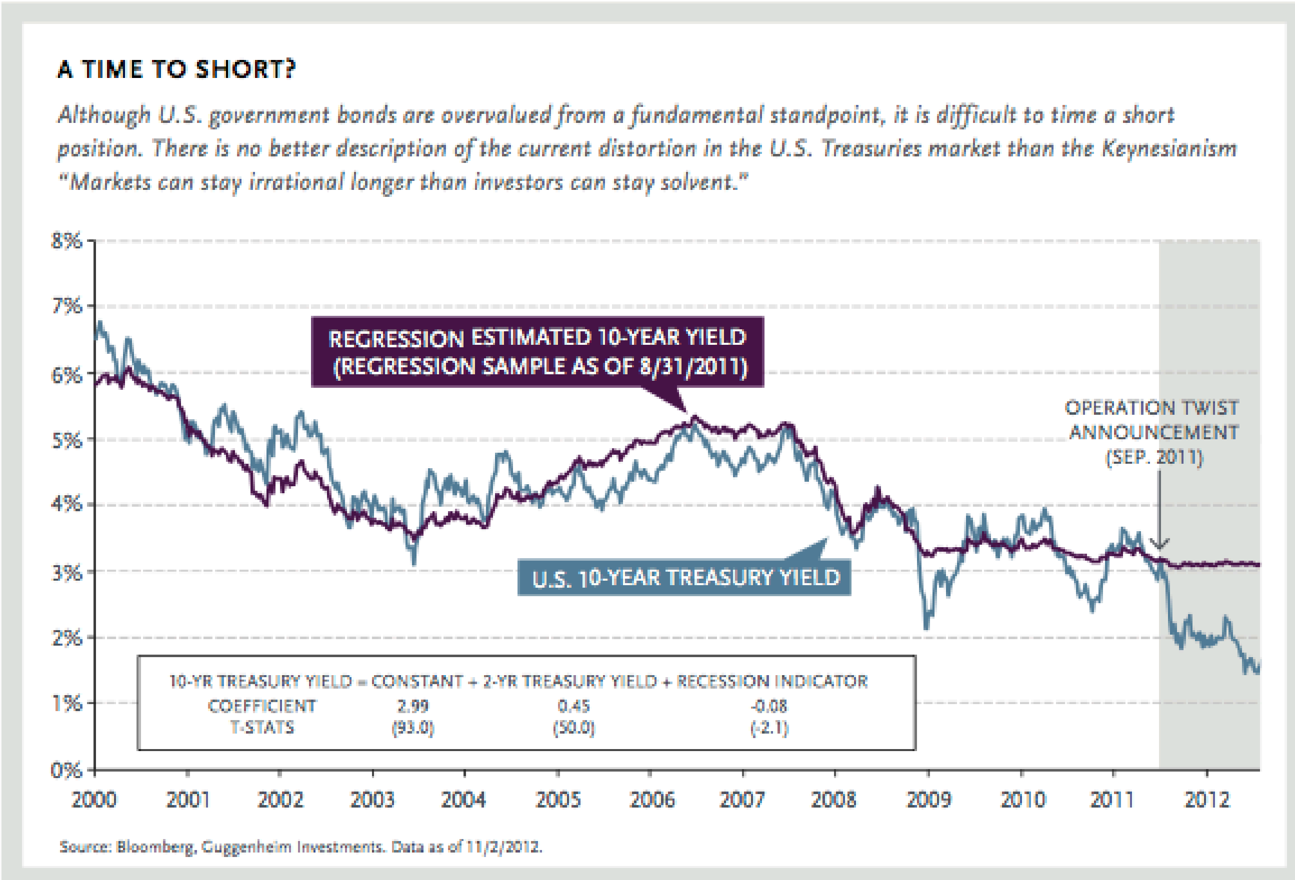
> ...By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens ... As inflation proceeds and the real value of the currency fluctuates wildly, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless.

Keynes re-iterated his views in the mid-1940s when he visited the United States and saw programs that were touted as Keynesian although he viewed them as primarily inflationary.

Financial repression is nothing new. Between the 1940s and the early 1980s, the United States reduced its national debt from 140 percent of GDP to just 30 percent while continuing to run sizable deficits. The difference between then and now is the magnitude of the debt mountain on the Federal Reserve's balance sheet that will need to be eroded. A subtle shift has begun in which policymakers are starting to think of inflation as a policy tool rather than the byproduct of their actions. Despite Keynes' warnings, it appears that higher inflation will continue to be the monetary tool of choice for central bankers tasked with cleaning up sovereign balance sheets.

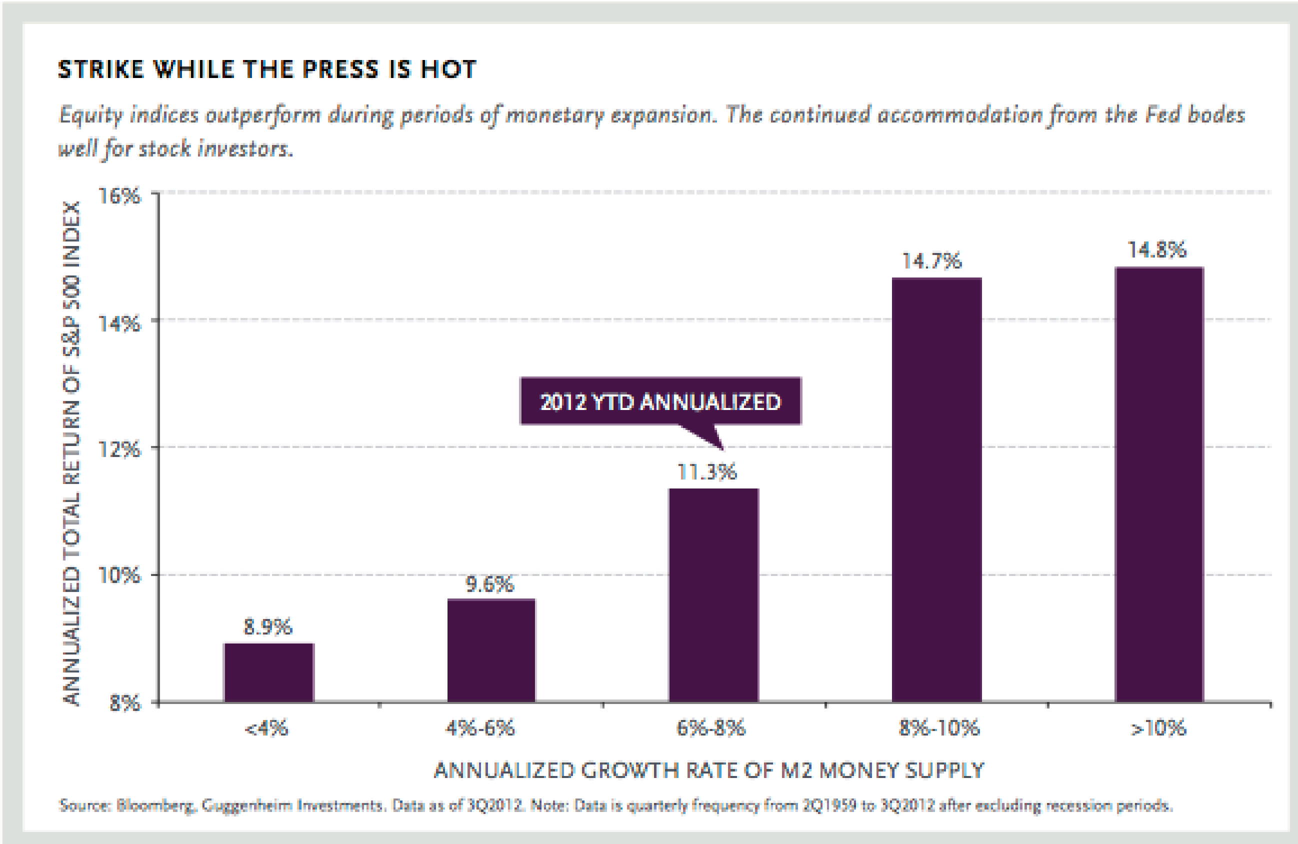
Investment Implications

The long-term downside of mounting inflationary pressure will ultimately accrue to bondholders and income-oriented investors. The case can be made that we are marching headlong into a generational bear-market for bonds. During the next decade, holders of Treasury and agency securities will likely realize negative real returns. Despite this, these assets continue to trade at extremely rich valuations. Exactly when the market will awaken to this anomaly in securities pricing remains to be determined. The analogy I would use for the current interest rate environment is that of a balloon being held underwater. When the Fed withdraws from the market and allows interest rates to find their economic level, the balloon will inevitably ascend.



If investors need to stay in fixed-income assets, they should consider transitioning into shorter-duration credit and floating-rate products like bank loans and asset-backed securities. If duration targeting is a concern for liability-matching purposes, adjustable-rate assets can be barbelled with long-duration securities like corporate bonds or long duration agency mortgage securities. Equities and risk assets are likely to rise as the money supply grows.

Gold, as I discussed in my October 2012 Market Perspectives, "Return to Bretton Woods," has significant upside potentially and should be considered for inclusion in any portfolio designed to preserve or grow wealth over the long-term. Depending on the scale of the current round of quantitative easing and the decline in confidence in fiat currencies, the price of an ounce of gold could easily exceed $2,500 within a relatively short time frame and could ultimately trade much higher.



The World is Waiting

The Great Depression brought about the Keynesian Revolution, complete with new analytical tools and economic programs that have been relied upon for decades. The efficacy of these tools and programs has slowly been eroded over the years as the accumulation of policy actions has reduced the flexibility to deal with crises as we reach budget constraints and stretch the Fed's balance sheet beyond anything previously imagined. Nations have exceeded their ability to finance themselves without relying on their central banks as lenders of last resort and increasingly large doses of monetary policy are required just to keep the economy expanding at a subpar pace. Some have referred to this as reaching the Keynesian endpoint.

Keynes would barely recognize where we now find ourselves. In this ultra loose policy environment we are limited by our Keynesian toolkit. Today, the world is waiting for someone to come forward and explain how we are going to get out of our current circumstances without suffering the unintended consequences created by so-called Keynesian policies.

Early in his life, Abraham Lincoln wrote that he regretted not having been present during the founding of the nation because that was when all the positions in the pantheon of great American leaders were filled. By resolving America's Imperial Crisis through the Civil War and the abolishment of slavery, Lincoln would go on to join those lofty ranks himself. Much like that crisis needed Lincoln, the current crisis needs someone who can identify new tools to resolve the present economic crisis. Until then we are condemned to a path which leads to further currency debasement and the erosion of purchasing power, with the result being a massive transfer of wealth from creditor to debtor. Without a new economic paradigm, the deleterious consequences of the current misguided policies are a foregone conclusion. It would seem my Dad could hardly have been more correct when he described the next depression from behind the wheel of his 1969 Buick.

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