The Great Balancing Act
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Puerto Vallarta and New Orleans

By John Mauldin

Last week we looked at change, and this week we turn our attention to balance, or more precisely, the dangers and opportunities of imbalance. Stock markets, currencies, confidence and government will be our target today for what should be an interesting and thoughtful letter.

I have been "saving" this topic for several months, waiting for the arrival of Bill Bonner's new book, ***Financial Reckoning Day***. It has launched at #4 on the Wall Street Journal Best-seller list as well as #8 on the New York Times list. (Jimmy Rogers wrote a great forward.)

For the reasons I outline, I think this is a book you should buy and read. What you will find is a book that goes to the heart of the controversy between Ludwig von Mises and John Maynard Keynes, two of the greatest economic minds of the last century. Does imbalance lead to hard correction or can it be managed back to balance? Do "managing" imbalances lead to more imbalance and bigger problems, or does it make any correction easier than it would have been?

Comprehending this debate is central to understanding the ebb and flow of economies and markets. It will also point the astute investor to large trend investment opportunities (like the drop of the dollar, for instance). Bonner (and his co-author Addison Wiggin) lay out the case for the problems associated with imbalance. They make the case for the Austrian school of economics founded by Ludwig von Mises, but in a far more readable manner.

For Bonner and Wiggin, the Austrian premise can best be summed up as the "Ought to" school of economics. When things get out of balance, they "Ought to" come back into balance. And for Austrians, that means without government and central bank meddling as espoused by Keynes, which in their mind simply creates more imbalance that will have to be dealt with. Did expanding the money supply create the Japanese and US stock market bubbles? Did aggressive lowering of rates create a housing price imbalance or did it soften a recession? Do US trade and government deficits create an imbalance which will end badly or do they stimulate an economy, producing jobs and get the economy "back on track?"

You can get the book at Amazon.com:
http://www.amazon.com/exec/obidos/ASIN/0471449733/frontlinethou-20

Ought To versus Feel Good

Let's read a few paragraphs from the book and then make some comments.:

"Modern economists no longer believe in ought. They do not appreciate her moral tone and try to ignore her. To them, the economy is a giant machine with no soul, no heart . . . no right and no wrong. It is just a matter of finding the accelerator.

"The nature of the economist's trade has changed completely in the past 200 years. Had he handed out business cards, Adam Smith's would have borne the professional inscription 'Moral Philosopher,' not 'Economist.' Smith saw God's 'invisible hand' in the workings of the marketplace. Trying to understand how it worked, he looked for the Oughts everywhere. Everywhere and always people get what they deserve, Smith might have said. And if not . . . they ought to!

"Today, the 'Ought to' school of economics has few students and fewer teachers. Most economists consider it only one step removed from sorcery.

"Call it [the Austrian School] the overinvestment theory of recessions of 'liquidationism,' or just call it the 'hangover theory,' " Paul Krugman [Princeton Professor and op-ed writer for the NY Times] began his critique of the 'Ought to' school. "It is the idea that slumps are the price we pay for booms, that the suffering the economy experiences during a recession is a necessary punishment for the excesses of the previous expansion.

"Deep economic problems are supposed to be a punishment for deep economic sins," Krugman continued in June 1998. Krugman elaborated the concept in December of the same year. The 'hangover theory,' he called it—referring to the way a man feels after he has been on a drinking binge. The hangover theory is 'disastrously wrongheaded,'" Krugman explains. "Recessions are not necessary consequences of booms. They can and should be fought, not with austerity but with liberality—with policies that encourage people to spend more, not less."

"What kind of world is it? Is it one in which a man can cure a hangover by getting drunk or get out of debt by borrowing more? Or is there a price to be paid for foolishness, collectively as well as individually? Is the world just a fine-tuned machine where a capable public servant can simply turn a screw or tighten a knob to make history turn out the way he wants? Or is it an infinitely complicated, natural thing as prone to error as a mob of teenage delinquents.

"The hangover theory is perversely seductive—not because it offers an easy way out, but because it doesn't," he continued in his December 1998 attack. "Powerful as these seductions may be, they must be resisted, for the hangover theory is disastrously wrongheaded," he concluded.

"In Krugman's mechanistic world, there is no room for Ought. If the monetary grease monkeys after the Great Depression of the 1930s or in Japan of the 1990s had failed to get their machines working, it was not because any invisible hands were at work or they were ignoring nagging moral principles to be reckoned with . . . but because they had not managed to turn the right screws!

"It is completely incomprehensible to the Keynesians of the world [like Krugman] that there may be no screws left to turn or that the mechanics might inevitably turn the wrong screws as they play out their roles in the morality spectacle."

An easy example of an imbalance is the US trade deficit. We now buy $500 billion more goods and services from foreigners than we sell EVERY YEAR. In two years that is $1 trillion. In four years it adds up to over $2 trillion.

What will those foreign holders of dollars do? They have already bought 46% of our free trading government bonds. Will they buy more? At what point do they think they have enough dollars and want something besides dollars. And mind you, this is a dollar which the Federal Reserve is bent upon inflating and the US treasury is bent on devaluing. At some point the prospect of doing business with the US may become more pain than pleasure, and the value of the dollar falls.

The "Ought to" school says this trade deficit should stop, and that governments should stop manipulating the values of currencies. If this continues, it will create a significant and painful correction.. The dollar should be allowed to fall in value. But they were saying that years ago, when the deficit was half of what it is today, and the parade has yet to end.

Gunning the Economy

We are watching it end before our eyes. The dollar is dropping. Yet there are a lot of "Ought to's" that are not happening. If the dollar is dropping in value, then import prices should be rising and our trade deficit ought to be falling. Yet today Greg Weldon tells us in his powerhouse Money Monitor. (www.macro-strategies.com)

"How is this supposed to 'work' according to all those Econ-101 text books that we NEVER read??? Is not a depreciating currency supposed to INCITE domestic price inflation, when imported goods begin to cost MORE??? Is not a depreciating currency supposed to INCITE export growth, when exported goods become CHEAPER overseas???

"Is not this entire scenario SUPPOSED to HELP … rebalance … the massively skewed trade imbalance, via the import-export dynamic stated above ??? Guess NOT."

"Again, we THROW OUT the Econ-101 text, and command the new world order, as a near RECORD 12-month depreciation of the US Dollar has NOT caused Import price inflation, nor has it caused Export prices to become more 'competitive.'

Bottom line, ISM Import Indexes SOARED, because of LOWER Import Prices, as revealed in today's report revealing a (-) 0.2% yr-yr pace of Consumer Goods ex-Autos Import Price DEFLATION."

I am as amazed as Greg. How can this be? I stop on my way to the airport and made one last note to this letter. This morning's trade balance numbers showed exports actually falling. The theory is that a lower dollar is supposed to make it rise.

Yet, the answer is simple. The rest of the world is so addicted to the American consumer for their sales, they are willing to take even fewer dollars which are worth even less just to keep their treadmill going. Their governments are following the advice that Krugman (and Keynes) gave above:

"(Recessions) can and should be fought, not with austerity but with liberality—with policies that encourage people to spend more, not less."

The rest of the world staves off a recession in their own countries that would come from selling less by encouraging the US to buy more. They do this with cheaper currencies and cheaper prices. Thus, our trade deficit soars even as the dollar drops, something that as Greg notes, our old Econ 101 textbooks tell us should not happen. (Today's small drop in the trade deficit still leaves the annual number at $500 billion. As Krugman is working on a new economics textbook, maybe he can explain this new world paradigm.)

Yet we are counseled to do the same. Weldon noted that Dallas Fed president Robert McTeer said yesterday:

"From a macro-economic perspective, it's a simple problem. All you have to do is run the economy hotter. We've just got to gun the economy so that demand is great enough to spur job creation."

In the long run, the "Ought to" school is right. Imbalances will be corrected. Bubbles and imbalances always function as a lean mean reversion machine. I should note that undervaluation works just the opposite. Things which are cheap will one day become dear.

But it might not happen as fast as it ought to, nor in the manner in which anyone thinks. In fact, it could be a very long time and a very long run indeed. We could Muddle Through for quite some time.

History teaches us that the longer an imbalance lasts, the larger a bubble inflates, the more a market strays from trend, the more significant the correction will be. Remember Jeremy Grantham's study of 29 different bubbles? They all corrected far below trend after the bubble burst.

The dollar, for instance, is likely to fall further than it should. Just as the world holds it now because they are confident in its future, they will leave when they lose that confidence. It will not happen overnight, thankfully. It will take years. There will be time to adjust.

Most of my US readers have been through a 30% drop in the value of the dollar, and few of you felt any ill effects. That was in the 1980's. The Europeans just saw their currency fall 30% and rise back to where it started in the space of slightly more than three years. The wheels have yet to drop off. We often speak of such events in dire tones. It is frequently far less than dire and often is seen in the mundane adjustments of individual lifestyles.

But that does not mean there are not opportunities. Those of my readers who first called Chuck Butler at Everbank and opened Eurodollar accounts back in the February of 2002 when I first turned bearish on the dollar are quite happy now. The dollar has not finished its recovery to balance. You can buy a CD denominated in dozens of different foreign currencies at Everbank, which is a US FDIC insured bank. You can even open a Chinese Renminbi account. Chuck's number is 800-926-4922. (Please note Everbank is a sponsor of my publisher's website.)

You should buy Bonner's book and read it. Yes, Bonner sees a somewhat darker future than my Muddle Through scenario, but that aside, I think the book will help you understand the nature of the imbalances in our world.

The book should only be considered gloom and doom if your future retirement is inextricably tied to a 10% forever compounding of the S&P 500 (see more on that below). The correction of imbalance leads to other significant opportunities, as all great macro traders know. The avoidance of the negative effects of the correction process is a key factor in preserving and increasing investment wealth.

Long time readers of Bonner can see the clear contributions to this work Addison Wiggin makes. That being said, I have been reading Bill for many years, and his thoughtful personal writing style is all over this book. That is a very good thing. Bonner makes me think, and he will make you think, too. Do I agree with every word? No, but if you only read people who think like you, you will soon find you do not do much thinking. It is in the arena of ideas that the blade of the mind gets sharpened. Bonner is a writer's writer, one of the best crafter of words I know, and simply a pleasure to read, even if his words are sobering. I have told Bill that there are times when I read his prose and feel like a housepainter in front of a Rembrandt. He is that good. The last chapter alone is worth the price of admission.

Click on this link to Amazon if it is sold out in your area, as it is flying off the bookshelves. My congratulations to Bill and Addison for making the bestseller lists right out of the box.

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Speaking of imbalances, Bill Bernstein and Rob Arnott have just published a rather stunning analysis of stock market earnings in the latest Financial Analysts Journal called: **Earnings Growth: The Two Percent Dilution.** Let me quote from the introduction and then comment:

"Two important concepts played a key role in the bull market of the 1990s. Both represent fundamental flaws in logic. Both are demonstrably untrue. First, many investors believed that earnings could grow faster than the macroeconomy. In fact, earnings must grow slower than GDP because the growth of existing enterprises contributes only part of GDP growth; the role of entrepreneurial capitalism, the creation of new enterprises, is a key driver of GDP growth, and it does not contribute to the growth in earnings and dividends of existing enterprises. During the 20th century, growth in stock prices and dividends was 2 percent less than underlying macroeconomic growth.

"Second, many investors believed that stock buybacks would permit earnings to grow faster than GDP. The important metric is not the volume of buybacks, however, but net buybacks—stock buybacks less new share issuance, whether in existing enterprises or through IPOs. We demonstrate, using two methodologies, that during the 20th century, new share issuance in many nations almost always exceeded stock buybacks by an average of 2 percent or more a year. The bull market of the 1990s was largely built on a foundation of two immense misconceptions. Whether their originators were knaves or fools is immaterial; the errors themselves were, and still are, important.

"Investors were told the following:

1. With a technology revolution and a "new paradigm" of low payout ratios and internal reinvestment, earnings will grow faster than ever before. Real growth of 5% will be easy to achieve. Like the myth of Santa Claus, this story is highly agreeable but is supported by neither observable current evidence nor history.

2. When earnings are not distributed as dividends and not reinvested into stellar growth opportunities, they are distributed back to shareholders in the form of stock buybacks, which are a vastly preferable way of distributing company resources to the shareholders from a tax perspective. True, except that over the long term, net buybacks (that is, buybacks minus new issuance and options) have been reliably negative.

"The vast majority of the institutional investing community has believed these untruths and has acted accordingly. Whether these tales are lies or merely errors, our implied indictment of these misconceptions is a serious one…"

Arnott and Bernstein, two of the more well-respected analysts in America (and deservedly so – Arnott is now editor of the FAJ) show that not only in the United States, but in 15 other countries, that earnings growth for corporations was below GDP growth.

What happened is that when you measure earnings growth from a “trough” or valley in the early 90’s to a peak in 1999, that measurement does indeed show significant growth. But that is a false methodology. You should always measure from peak to peak or from trough to trough to get an accurate picture.

When measured over decades, the “growth” reverts to the mean. Yet investors were told to project the recent trend into the future. We are in a “new paradigm”, we were told. We are seeing how that concept is bogus. There have been several periods in the last few centuries when technological changes have been made which had far larger impact on lifestyle than the ones of today. In each of those cases, they were told that this time “Things are different.” They never are. Investors seem to always project the current trend into the forever, and it does not last into the forever.

Yet it should be intuitively obvious that earnings for US corporations cannot grow faster than the economy for any length of time. Consider the hypothetical economy of the country of Fantasia. (By the way, Arnott and Bernstein would not stoop to such a simplistic analogy, but I don’t have to worry about my reputation.)

Assume the economy of Fantasia grows by 5% a year and earnings of Fantasian corporations grow by 10% a year. Earnings are 10% of the total GDP or economy. After 14 years, the economy will double. But earnings will have risen by 4 times! Earnings will now be 20% of the economy. If this process were to continue for a few decades, earnings would soon be 100% of the economy. The parts cannot grow larger than the whole.

What their research shows is that earnings not only do not grow faster than the economy, they grow slower. While specific companies can do well for periods of time, other research clearly shows that sustained compounded high growth over decades is very, very rare. And when applied to broad segments of the market, it just does not happen.

(How can S&P 500 earnings grow faster than the economy, as they do? Because each year, slow moving dogs are dropped and fast growing companies are added. I believe I recently read that 370 new companies have been added to the elite list of 500 as others have been dropped in just the last 30 years or so. So much for buy and hold.)

I remember reading an analyst in early 2000 who breathlessly wrote that the stocks of Microsoft and Intel would do as well in the coming decade as they did in the past decade. I pointed out that if this were true, in just 12 years, the market value of the two stocks would be more than the entire GDP of the country.

Tokyo real estate in 1989 was not really worth more than all of California, although that is what the prices at the time indicated, and Microsoft and Intel, no matter how wonderful they are, cannot be worth more than the entire economy. There is a balance.

Arnott and Bernstein conclude their research with these sobering remarks:

"The markets are probably in the eye of a storm and can expect further turmoil as the rest of the storm passes over. If normalized S&P 500 earnings are $30–$36 per share, if payout ratios on those normalized earnings are at the low end of the historical range (implying lower-than-normal future earnings growth), if normal earnings growth is really only about 1 percent a year above inflation, if stock buybacks have been little more than an appealing fairy tale, if the credibility of earnings is at an all-time low, and if demographics suggest Baby Boomer dis-saving in the next 20 years, then we have a problem."

Puerto Vallarta is Calling, Meet me in New Orleans

Last week I gave the wrong link to the site for my Congressional testimony on hedge funds. I apologize. For those who are interested, I recently testified before Congress on why hedge funds should be available to everyone and one way to accomplish that. You can read that testimony at www.accreditedinvestor.ws. That is also where you can subscribe to my free e-letter on private offerings, hedge funds and alternative investments. You must be an accredited investor and be approved to receive the letter. You can read about the letter, as well as the risks in hedge funds, at the site. (In this regard, I am a registered representative of the Williams Financial Group, a NASD member firm.)

I am writing this letter on Thursday (and Friday very early) as I leave tomorrow morning for a long weekend with my bride in Puerto Vallarta. Normally, I am not allowed to bring work to PV, but this time I will have my computer, busily working on my book. I have promised my publisher the book will be in their office by November 14. No more research. Just writing, and more writing.

Here is a link to the web page for the New Orleans conference October 29 through November 1. Join me, Bill O'Reilly, Richard Russell and Jim Rogers, (and yes, Bill Bonner) plus a host of excellent investment analysts at one of the more fun events I attend each year. http://www.neworleansconference.com/event/faculty2003.htm#mauldin Let me know if you are coming, as I will be doing some private sessions just for my readers. For those who have written about meeting, I will be getting back to you next week.

On a reflective note, I have been thinking of late about how out of balance our lives can become if we are not too careful. It seems to be just as hard to see some of the imbalance in our own lives as it is to recognize the imbalance in the markets. But we can try. That is what friends (and maybe a few good market analysts) are for.

Your looking for some balance analyst,

John Mauldin