We Can't Take the Chance

By John Mauldin | August 10, 2013

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What would it have been like to be in the decision-maker's seat at a central bank in the midst of the crisis in 2008-09? You'd know that you won't have the luxury of going back and making better decisions five years later. Instead, you have to act on the torrent of information that's coming at you from every quarter, and none of it is good. Major banks are literally collapsing, the interbank market is almost nonexistent, and there is panic in the air. Perhaps you feel that panic in the pit of your stomach. This week we'll perform a little thought experiment to see if we can extrapolate what is likely to happen in when the next crisis kicks in.

This week's letter was triggered by a semiformal debate in Maine last week. David Kotok assembled about 50 economists, financial analysts, money managers, and media personalities to share a few days of fabulous food, what turned out to be great fishing, and awesome conversation. There were more Federal Reserve economists this year than in the past, as well as more attendees with the title "Chief Economist" on their business cards, many from large institutional names you would recognize. This was my seventh year to attend "Camp Kotok." David really did a marvelous job of bringing a diverse group of thinkers together, and I think everyone agreed this was the best conference ever. I learned a lot.

Before we get into the letter, a little side note. Luciana Lopez from Reuters attended for the first time this year and wanted to do interviews. David asked me if I would take her out on the lake in our boat, since most of the other attendees went out in small canoes. Trey and I were glad to share our space. While we were out fishing, she asked if she could interview me. I said "Sure" and waited for her to bring out her recorder. She pulled out an iPhone 5 and started asking questions. Not the usual studio setting I am used to. I had serious trepidations about how this was going to look on-screen.

She sent a link to her edited interviews last Monday, and I have to admit I was impressed at what she could do with a simple iPhone 5. I am supposed to be on top of a changing world, but sometimes these things still take me by surprise. I make no representations about the quality of the content of the interviews, at least my portion of them, but the phone is another matter. And in a few years this will be a $100 consumer item.

In her interviews, Luciana asked two questions: "When will the Fed start to taper?" and "Who will be the next Fed chair?" You can see some of our answers at reut.rs/13if7Er and reut.rs/13gegE8.

We Can't Take the Chance

On Saturday night David scheduled a formal debate between bond maven Jim Bianco and former Bank of England Monetary Policy Committee member David Blanchflower (everyone at the camp called him Danny). Jim Bianco needs little introduction to longtime readers, but for newbies, he is one of the top bond and interest-rate gurus in the world. His research is some of the best you can get – if you can get your hands on it.

Blanchflower needs a little setup. He is currently a professor at Dartmouth and has one of the more impressive resumés you will find. He is not afraid to be a contrarian and voted in the minority in 18 out of 36 meetings in which he participated as an external member of the Bank of England's interest rate-setting Monetary Policy Committee (MPC) from June 2006 to June 2009. (The MPC is the British equivalent of the US Federal Open Market Committee.) Blanchflower's *The Wage Curve,* drawing on 8 years of data from 4 million people in 16 countries, argued that the wage curve, which plots wages against unemployment, is negatively sloping, reversing the conclusion from generations of macroeconomic theory. "The Phillips Curve is wrong, it's as fundamental as that," Blanchflower has stated. Blanchflower is also known as the "happiness guru" for his work on the economics of happiness. He quantified the relationship between age and happiness and between marriage, sex, and happiness. Who knew that people who have more sex are happier? Well, we all did, but now we have economic proof.

I got to spend a good deal of time with Danny on this trip and enjoyed hearing him talk about what it was like to be responsible for setting monetary policy in the midst of a crisis. We also argued late into the night on a variety of subjects. He is an altogether fun guy as well as a professional who takes his economics seriously. He is far more mainstream than your humble analyst, as were many of the denizens of Camp Kotok. On the other hand, I can't think of a major stream of economic thought that wasn't represented aggressively at one point or another. If you have thin skin or weak data, this outing is one you might not enjoy. You need to bring your A game with this crowd.

The format for the debate between Bianco and Blanchflower was simple. The question revolved around Federal Reserve policy and what the Fed should do today. To taper or not to taper? In fact, should they even entertain further quantitative easing? Bianco made the case that quantitative easing has become the problem rather than the solution. Blanchflower argued that quantitative easing is the correct policy. Fairly standard arguments from both sides but well-reasoned and well-presented.

It was during the question-and-answer period that my interest was piqued. Bianco had made a forceful argument that big banks should have been allowed to fail rather than being bailed out. The question from the floor to Danny was, in essence, "What if the Bianco is right? Wouldn't it have been better to let banks fail and then restructure them in bankruptcy? Wouldn't we have recovered faster, rather than suffering in the slow-growth, high-unemployment world where we find ourselves now?"

Blanchflower pointed his finger right at Jim and spoke forcefully. "It wasn't the possibility that he was right that preoccupied us. We couldn't take the chance that he was wrong. If he was wrong and we did nothing, the world would've ended and it would've been our fault. We had to act."

That sentence has stayed with me for the past week: "We couldn't take the chance that he was wrong." Whether or not you like the implications of what he said, the simple fact is that he was expressing the reigning paradigm of economic thought in the world of central bankers.

Now, let's hold that train of thought for a few minutes as we introduce an essay by French geophysicist and complex systems analyst Didier Sornette and his colleague Peter Cauwels. Sornette is Professor on the Chair of Entrepreneurial Risks at the Department of Management Technology and Economics of the Swiss Federal Institute of Technology Zurich. (This introduction comes from work I have been doing in collaboration with Jonathan Tepper, my co-author for *Endgame*.)

By far the biggest advances in understanding the dynamics of bubbles in recent years have come from Sornette. He has developed mathematical models to explain earthquake activity, Amazon book sales, herding behavior in social networks like Facebook, and even stock market bubbles and crashes. He wrote a book titled *Why Stockmarkets Crash*. He found that most theories do a very poor job of explaining bubbles.

Sornette found that log-periodic power laws do a good job of describing speculative bubbles, with very few exceptions. Classic bubbles tend to have a parabolic advances with shallow and increasingly frequent corrections. Eventually, you begin to see price spikes at one-day, one-hour, and even ten-minute intervals before crashes.

After a crash, journalists go looking for the cause. They'll blame something like portfolio insurance for the crash of 1987 or the bankruptcy of Lehman Brothers for the Great Recession, rather than blaming a fundamentally unstable market. Sornette disagrees:

> Most approaches to explain crashes search for possible mechanisms or effects that operate at very short time scales (hours, days or weeks at most). We propose here a radically different view: the underlying cause of the crash must be searched months and years before it, in the progressive increasing build-up of market cooperativity or effective interactions between investors, often translated into accelerating ascent of the market price (the bubble). According to this "critical" point of view, the specific manner by which prices collapsed is not the most important problem: a crash occurs because the market has entered an unstable phase and any small disturbance or process may have triggered the instability. Think of a ruler held up vertically on your finger: this very unstable position will lead eventually to its collapse, as a result of a small (or absence of adequate) motion of your hand…. The collapse is fundamentally due to the unstable position; the instantaneous cause of the collapse is secondary. In the same vein, the growth of the sensitivity and the growing instability of the market close to such a critical point might explain why attempts to unravel the local origin of the crash have been so diverse. Essentially, anything would work once the system is ripe.

Sornette's conclusion is that a fundamentally unstable economic system plus human greed means that market bubbles and crashes won't disappear anytime soon."

A Few Impossible Things

I want to focus on the recent paper Sornette wrote with Cauwels, entitled "The Illusion of the Perpetual Money Machine." I'm going to quote a few paragraphs from the introduction. They begin with that marvelous exchange from *Alice in Wonderland:*

> *There is no use trying," said Alice. "One can't believe impossible things."*
> *"I daresay you haven't had much practice," said the Queen. "When I was your age, I always did it for half an hour a day. Why, sometimes I've believed as many as six impossible things before breakfast."*
> *– Lewis Carroll*
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> Chasing fantasies is not the exclusive pastime of little girls in fairy tales. History is speckled with colorful stories of distinguished scientists and highly motivated inventors pursuing the holy grail of technology: the construction of a perpetual motion machine. These are stories of eccentric boys with flashy toys, dreaming of the fame and wealth that would reward the invention of the ultimate gizmo, a machine that can operate without depleting any power source, thereby solving forever our energy problems. In the mid-1800s, thermodynamics provided the formal basis on what common sense informs us: it is not possible to create energy out of nothing. It can be extracted from wood, gas, oil or even human work as was done for most of human history, but there are no inexhaustible sources.
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> What about wealth? Can it be created out of thin air? Surely, a central bank can print crispy banknotes and, by means of the modern electronic equivalent, easily add another zero to its balance sheet. But what is the deeper meaning of this money creation? Does it create real value? Common sense and Austrian economists in particular would argue that money creation outpacing real demand is a recipe for inflation. In this piece, we show that the question is much more subtle and interesting, especially for understanding the extraordinary developments since 2007. While it is true that, like energy, wealth cannot be created out of thin air, there is a fundamental difference: whereas the belief of some marginal scientists in a perpetual motion machine had essentially no impact, its financial equivalent has been the hidden cause behind the current economic impasse.

> The Czech economist Tomáš Sedláček argues that, while we can understand old economic thinking from ancient myths, we can also learn a lot about contemporary myths from modern economic thinking. A case in point is the myth, developed in the last thirty years, of an eternal economic growth, based in financial innovations, rather than on real productivity gains strongly rooted in better management, improved design, and fueled by innovation and creativity. This has created an illusion that value can be extracted out of nothing; the mythical story of the perpetual money machine, dreamed up before breakfast.
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> To put things in perspective, we have to go back to the post-WWII era. It was characterized by 25 years of reconstruction and a third industrial revolution, which introduced computers, robots and the Internet. New infrastructure, innovation and technology led to a continuous increase in productivity. In that period, the financial sphere grew in balance with the real economy. In the 1970s, when the Bretton Woods system was terminated and the oil and inflation shocks hit the markets, business productivity stalled and economic growth became essentially dependent on consumption. Since the 1980s, consumption became increasingly funded by smaller savings, booming financial profits, wealth extracted from house prices appreciation and explosive debt. This was further supported by a climate of deregulation and a massive growth in financial derivatives designed to spread and diversify the risks globally.
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> The result was a succession of bubbles and crashes: the worldwide stock market bubble and great crash of 19 October 1987, the savings and loans crisis of the 1980s, the burst in 1991 of the enormous Japanese real estate and stock market bubbles and its ensuing "lost decades", the emerging markets bubbles and crashes in 1994 and 1997, the LTCM crisis of 1998, the dotcom bubble bursting in 2000, the recent house price bubble, the financialization bubble via special investment vehicles, speckled with acronyms like CDO, RMBS, CDS, … the stock market bubble, the commodity and oil bubbles and the debt bubbles, all developing jointly and feeding on each other, until the climax of 2008, which brought our financial system close to collapse.
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> Each excess was felt to be "solved" by measures that in fact fueled following excesses; each crash was fought by an accommodative monetary policy, sowing the seeds for new bubbles and future crashes. Not only are crashes not any more mysterious, but the present crisis and stalling economy, also called the Great Recession, have clear origins, namely in the delusionary belief in the merits of policies based on a "perpetual money machine" type of thinking.
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> The problems that we have created cannot be solved at the level of thinking we were at when we created them." This quote attributed to Albert Einstein resonates with the universally accepted solution of paradoxes encountered in the field of mathematical logic, when the framework has to be enlarged to get out of undecidable statements or fallacies. But, the policies implemented since 2008, with ultra-low interest rates, quantitative easing and other financial alchemical gesticulations, are essentially following the pattern of the last thirty years, namely the financialization of real problems plaguing the real economy. Rather than still hoping that real wealth will come out of money creation, an illusion also found in the current management of the on-going European sovereign and banking crises, we need fundamentally new ways of thinking."

And with that biting critique of central bank policy making, we come back to Blanchflower's fateful line: "We couldn't take the chance that he was wrong."

Without a fundamental shift in economic thought at the highest levels of central banking, there is little doubt that the response of any central bank during the next crisis – and there will always be a next crisis – will be more the same. Central banks will again apply the limited tools they have: low interest rates, quantitative easing, a variety of bailout mechanisms – in short, they will resort to the financial repression of savers in the name of the greater good.

Jim Bianco can argue, far more eloquently than your humble analyst, that savers should be rewarded, not punished; that financial repression should only be practiced *in extremis;* and that moral hazard should be respected. But the reality is that the people with their hands on the levers simply believe with all their hearts in a different theoretical economic framework and will not take a chance on being wrong. They will act just as they have in the past.

I would argue, and I think Sornette would agree, that the current policies are simply increasing the instability of the entire system, leading up to another major dislocation in the not-too-distant future. In much the same way that everyone loved rising house prices in the middle of the last decade, we all find contentment in a rising stock market now. For Bernanke and his kin, the markets simply confirm the correctness of their policies. "More cowbell!" is the economic order of the day.

As Sornette put it, "Each excess was felt to be 'solved' by measures that in fact fueled following excesses; each crash was fought by an accommodative monetary policy, sowing the seeds for new bubbles and future crashes."

Richard Fisher, Dallas Federal Reserve President, has been arguing forcefully that the Fed needs to begin tapering its quantitative easing. He is part of a growing chorus that is increasingly uncomfortable with the potential unintended consequences of massive accommodation and the financial repression of savers. Let us hope they are gaining a hearing.

Thinking About Alternatives

Last week I started my letter with a simple but vehement question: "What in the world is going on?!" In seeking an answer to that question, we examined some data points in the market and highlighted the idea of diversifying into alternative investment strategies as a means of balancing our portfolios during this precarious period. This week I want to follow up that discussion with a note on an important topic with regard to evaluating alternative investment funds: manager selection and the concept of performance dispersion.

In the alternative investment arena, a manager's efforts to deliver higher, risk-adjusted returns can produce huge returns … or significant losses. Therefore, performance dispersion – the difference between the best- and worst-performing funds can be quite large. To avoid finding themselves toward the bottom of that spread, investors should select a fund manager carefully

My partners at Altegris have produced a timely strategy paper titled "All Managers Are Not Created Equal" that illustrates why manager selection is such an important part of the alternative investment process. Written by my good friend Jon Sundt, President and CEO of Altegris, the piece does a great job of covering both the opportunities and the challenges presented to investors when they choose an alternative investment manager. I encourage you to download and study this paper in detail if you are looking to diversify into alternative investments.

14 Years and Counting

It was 14 years ago this week that I began publishing *Thoughts from the Frontline* on the internet, on a more or less weekly basis. All the letters from January 2001 on – the good, the bad, and the embarrassing – can be found in the archives at http://www.mauldineconomics.com. That is close to 7000 pages of commentary, some of which I'm proud of and some of which I'd like to bury in the deepest, darkest parts of the internet. Together, you and I have gone through recessions, bull and bear markets, credit crises, and several bubbles, and we have examined at least 100 different topics.

I started with 2,000 email addresses and must admit I never thought at the beginning that I would attract such a wide audience. We will be doing another survey soon, but the past surveys have shown that about 25% of you live outside of the United States. The majority of you are very well-educated and reasonably affluent; but in a list as large as this we go from people who are self-educated or just beginning their education to PhDs and people with immense experience, and from people who are just beginning to accumulate net worth to a few readers who have already amassed billions. I've had the pleasure of meeting many of you and corresponding with many more over the years. I am constantly amazed at the thoughtfulness and diversity of my readers, but the one constant seems to be that you are genuinely nice people. I look at the comments section on other writers' sites and compare them with the notes from my own readers, and it is obvious that you are a cut above the usual crowd. I am humbled by your support and proud of you as well. I am fully aware that the highest compliment any writer can receive is an allocation of time from his readers. I am truly grateful for being allowed to be part of your life.

My business model has changed over the years, and we anticipate a few more changes at Mauldin Economics in the coming year, all in the effort to serve you better. The one thing that will not change is this letter and my companion letter, *Outside the Box.* I will still write these every week, and they will remain free. You will continue to get my unvarnished opinions, the most interesting essays I can find, and the best macroeconomic guidance I can muster. When I began writing this letter, my prime motive was to help us all understand how the puzzle pieces fit together. That goal has not changed in 14 years. The puzzle seems to have gotten more complicated, so we have an even greater need today to assemble the jumble of pieces into a coherent picture.

Let me thank you from the bottom of my heart for being one of my readers. While it may sound a little corny, I have always thought of each of you as one of my closest friends. That is the way I approach writing the letter, much as if you and I were sitting at a corner table having a quiet conversation, informal yet intense, and animated with a sense of fun and the anticipation of discovery.

Here's to another 14 years of continued conversation.

Montana, San Antonio, Chicago, Bismarck, Denver, Toronto, NYC…

The list above sounds like a lot of travel, but somehow I am not gone that many days. I will be in Montana this week for R&R with my friend Darrell Cain at his home on Flathead Lake. I'll catch up on some reading and have some well-deserved rest, as I have just finished a major project that we will announce in a few months. As those around me know, I've been consumed by projects the past few months and am ready for a more normal life. Montana sounds perfect at the moment.

The weekend before Labor Day, I will be in San Antonio for the 71st World Science Fiction Convention, Lone Star Con 3, where I will get to hang out with some of my favorite writers and talk about both history and the future with guys who live in the past and the future (ignoring the present). I have never been to one of these, and the experience has long been on my bucket list.

Then I will be off to Chicago for a presentation (details to follow next week) and after that on to Bismarck, North Dakota, for a few days with BNC National Bank. Lacy Hunt will join me for an all-day conference with their clients, and I am pretty sure it will be open to the public. I'll also get an update from BNC and Loren Kopseng on the Bakken oil boom. If the stars line up right, I will take an extra day and fly down with my friend Loren to South Dakota. If that works out, I will be able to say I have been in all 50 states.

The next week I fly to Denver for a day to be with the team at Altegris Investments (details to follow), and then that next weekend I fly to Toronto to be with Louis Gave of GaveKal. There will be a seminar on Monday morning, Aug. 23rd. If you would like to attend, you can register at http://gavekal.com/seminar.cfm or contact Chris Lightbound with any questions. From Denver I will fly on to New York City for a few days for media and meetings. While that schedule may seem busy, it involves only about 10 nights away from home for the month, which is less than half of what I've been doing for the last year. I guess it's all relative.

And speaking of anniversaries, this week marks two years of not drinking. I can't say that I don't miss Chardonnays, but I value my health more. As Clint Eastwood said, "A man's got to know his limitations." I am seeing a lot of spectacular advances in the biotechnology world that we at Mauldin Economics will be writing about in the next few months, but I haven't yet come across a company with a pill that will let me metabolize alcohol with no ill effects on my body so that I can just enjoy the taste of the wine. Contrary to company policy, when I find that company I will probably invest in it first and then tell you about it. Just saying…

Have a great week and enjoy your summer. I see a weekend with kids and family and last-minute work on the big project I mentioned. But it's all good.

Your amazed at how it's all turned out analyst,

John Mauldin

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