



ATLANTIC CAPITAL MANAGEMENT

FROM COOKE TO HOOVER TO BERNANKE

Money Elasticity Demands Monetary Policy Set Its Sight On Bubble #5

SPECIAL INVESTMENT RESEARCH REPORT

February 2, 2011

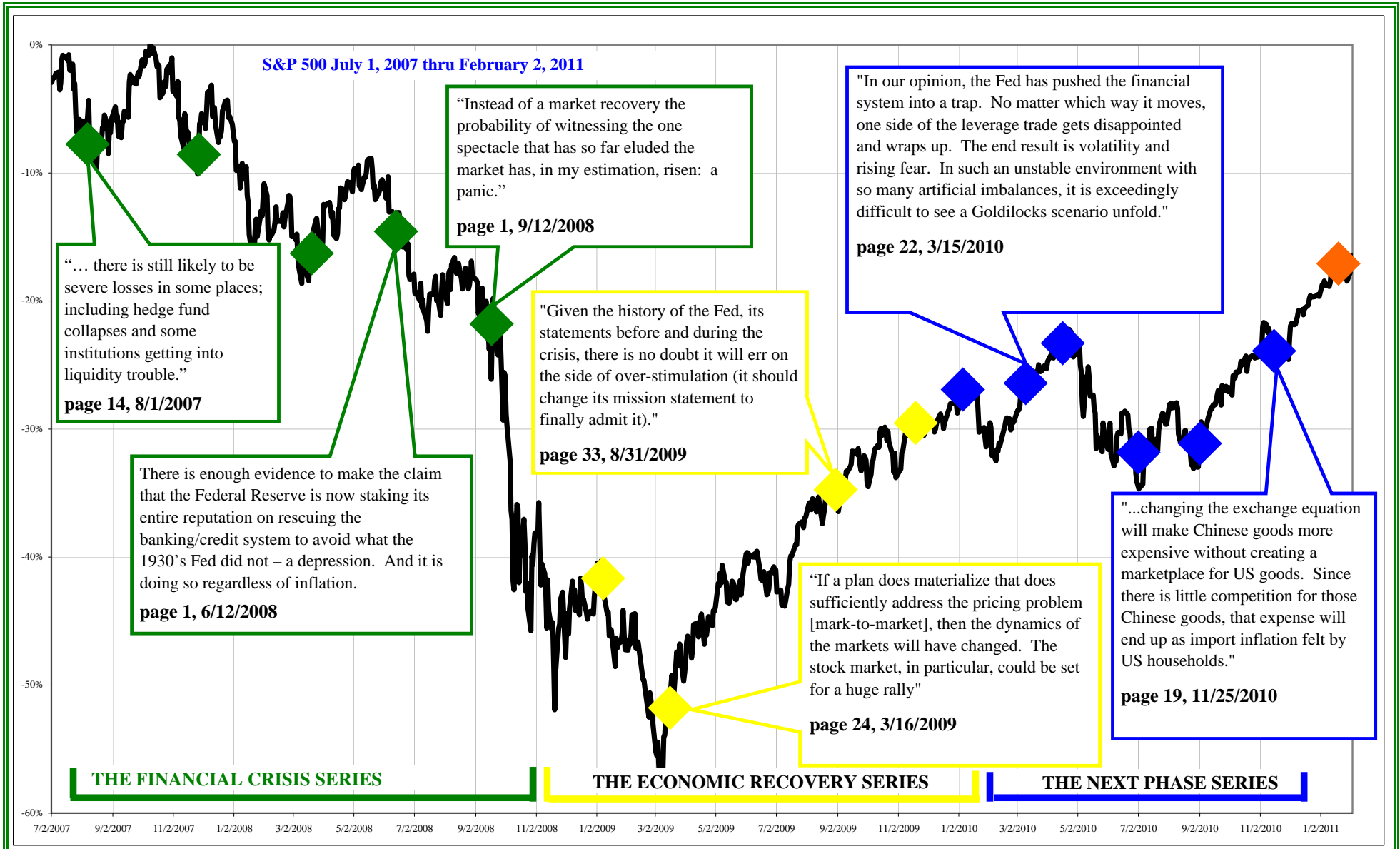
EDITION 1 **THE NEXT NORMAL SERIES**

Written By
Jeffrey P. Snider, President



ATLANTIC CAPITAL MANAGEMENT

research.acminstitutional.com



Our entire research archive is available at research.acminstitutional.com. To keep informed about our latest research and commentary, sign up for our regular investment newsletter, THE DYNAMIC INVESTOR REVIEW, at newsletter.acmwealthadvisors.com.

REPORT SUMMARY

The recovery bugs are out again even after the GDP report for Q4 2010 showed significant structural weakness. Inflation is spreading quickly and has already impacted businesses and households. The Fed will not do anything about it because its models say it isn't there. We show why those models are so confident (why you should be much less so), why inflation is a problem now, and why this latest bubble will not last six years like the last.

Part 1 – The Myth of Precision

No Fed policy is undertaken without a blessing from their models. Unfortunately their models are restricted to time series data, meaning that if events unfold different than they have in the recent past the models believe them to be unlikely or impossible. This is how the Fed missed 2008/09.

Now the Fed wants you to believe that it has incorporated the last three years into newer, improved models. But the improvement is minimal – by their own admission. Yet they still proclaim monetary policy is working and will end up creating or saving 3 million jobs (they liked the “stimulus” motto so much they are repeating it).

Monetary policy has led to malinvestment that has created all sorts of nasty consequences that are now rendering current policy completely ineffective.

Part 2 – The End is Nearer

The Fed is continually loosening monetary policy because it is deathly afraid of Fisher's Paradox about deflation. We question whether that was even a valid concern in 2008/09, let alone today. By pursuing inflation to counteract the threat of deflation we believe the Fed is simply extending Fisher's Paradox to unintended spaces.

Part 3 – Will Bernanke Equal Weimar?

Ever since the 19th century the elite has dreamed of controlling the economy. It became a reality through a distinct change in the idea of wealth. At the end of the Civil War Jay Cooke promoted the notion of government debt as wealth. Soon it would back bank currency and be equivalent to gold. By the time Hoover came to the presidency the Fed had given enough elasticity to currency (through inflation) to give authorities enough confidence to try to control the economy.

The last three years are challenging all the notions gained since Cooke. The threat of inflation and debt could undo the paper “wealth” built up during the past 100+ years. How the Fed responds to these threats will determine the ultimate fate of the latest inflationary bubble.

“It is not too hard in 2011 to imagine a situation where the productive economy cannot really afford the increase in confiscation through taxation without itself contracting (wasn't that the debate in December?). In this situation, all the paper wealth would drain itself backward toward the fundamental foundation of production potential. This vicious cycle starts when treasury debt interest costs force an increase in taxation, which reduces economic activity, forcing a further increase in taxation, which reduces economic activity, and so on. This would be the start of hyperinflation. At this point the Fed would have to monetize all the debt and interest payments, and the meaning of the US dollar would be not much greater than zero.”

“The recovery is finally here and it is sustainable, almost”. That seems to be the new mantra which is noticeably similar to the old mantra from the outset of 2010, minus all the talk of V’s, L’s and W’s. If only the animal spirits would come out of hibernation and feast on the free money the world’s massive problems (imbalances) would be solved. Finally.

The real debate going into 2011 is about the true role of money. The Fed says it can rekindle the profit instincts now buried within investors by making safety expensive and making sure the banking system has extra excess reserves.

Today’s money is aggregated by Wall Street banks, transmitting digital dollars into the real economy through interest rate interactions that favor/entice businesses and individuals to borrow with abandon. And if that doesn’t work the Fed will create “wealth” through asset price pushes, believing that if people and businesses “feel” wealthy the economy will revive.

What if we turn the Fed’s idea of money on its ear? What if we see the role of money as simply facilitating the exchange of goods and services? This exchange is somewhat affected by the cost of money but it is basically a function of the demand for the exchange of those goods and services. Then an exponential increase in the supply of money will drive down its cost without having any positive impact on the real economic exchange of goods and services.

This leads to the question we have been asking for a long time. Does a reduction in the cost of money always lead to an increase in the demand for exchanging goods and services? For the Fed the answer is unequivocally “yes”.

The “always” qualification within the above question is the most important part. Clearly there are times when reduced interest rates do stimulate real economic activity. But mainstream economists have backed themselves into a corner by taking this idea to its extreme. They believe that reducing the cost of money *will always* create real economic activity. So much so that they have built a “science” out of monetary policy in particular, and economics in general.

By defining, measuring, and controlling economic levers with mathematical precision they presume to reap benefits that such precision promises to deliver. If inflation heats up a little, Chairman Bernanke can control it in as little as fifteen minutes. If zero-bound interest rates seem to fail in their primary goal, the Fed



can simply increase the quantity of money through Wall Street. It has innumerable policy tools expertly designed by PhD's, backed by some of the most elegant mathematical equations and models in human history.

No matter how much the Fed, and the economics “profession”, try to make economics into a science they will always fail.

Economics is not a science. It never will be. It is the study of human interactions, so there can never be a level of precision akin to physics or geometry. It may create grandiose sounding rules and constructs, like Okun's Law, Say's Law or Fisher's Paradox, but these are not in any way “laws” like the Law of Gravity. They are more or less general guidelines that *seem* to hold through a *specific* time series.

The devotion to the myth of precision will always lead to imprecision. Because in creating the air of accuracy it is necessary to ignore the more inconvenient parameters of the insanely complex economic system. In other words, these “scientists” *have* to take shortcuts to create usable models and get meaningful results from them.

Inflation, the topic du jour of 2011, is just such a shortcut. In order for the modern science of economics to function, inflation has to be narrowly defined. For the Fed, inflation is the *general* rise in prices. Defined in this way the Fed can (and does) ignore an increase in volatile (code for “hard to predict”) food and energy because these are *specific* price increases, and thus do not fit the textbook definition.

Monetary policy is conducted with the narrow definition while the more complex aspects (code for “hard to quantify”) of monetary imbalances are simply ignored. If it cannot be modeled it does not matter to an economist. This includes asset inflation.

Asset inflation is just another form of inflation, another offshoot of too much money – bad monetary policy. It has decidedly bad side effects (which we will examine) that are not always apparent. The real cause of asset inflation is malinvestment. If there are indeed periods where a lower cost of money does not stimulate the real economy then we would expect to see malinvestment. Stated simply, if money does not create a demand for the exchange of goods and services then it will create an increasingly frenzied exchange of price assets, known to the world as asset bubbles.

The question of recovery is really a question of bubbles. This current recovery is closely tracking the weakness of the 2002-03 recovery. That one was kept alive by malinvestment for almost six years. So are we seeing another period of malinvestment? If so, how long can it last? How will it end?



Part 1 The Myth of Precision

The main pillar of monetary policy is that reduced cost of money and credit stimulates economic activity. By embarking on quantitative easing (QE 2.0) Chairman Bernanke intended explicitly to stimulate a flagging economy with low interest rates. Curiously, rates have risen significantly since the implementation of QE 2.0.

At the end of QE 1.0 in March 2010 interest rates began to accelerate higher, if only for a short period. From April through the rest of the summer interest rates continually fell, leading many to believe that deflation was being priced by the credit market while stocks held onto the dream of the V-shaped recovery for a short while. Then stocks faltered and joined bonds in beginning to discount some rough times ahead. We were fooled into this conclusion if only because we forgot our first rule of government interventions – they largely disable price discovery.

Now that the economy *seems* to have picked up some recovery steam the economists are patting themselves on the back for a job well done. They reconcile the backward rate movement as proof that those schizophrenic bonds are now pricing for economic growth, despite the main pillar of monetary policy. So what is the credit market actually signaling?

As uncomfortable as it may be to many people's sensibilities, the truth may be that these interest rate movements are trying to signal absolutely nothing. They are completely and utterly *meaningless*. It is entirely plausible that the rising interest rates in the beginning of April 2010 caused primary dealers to jump back into the treasury auctions with the idea that the Fed would be forced into another round of QE. Since QE is nothing more than the Fed buying US Treasuries at favorable prices it was something akin to an arbitrage

opportunity – outsized gains with little perceived risk. Some people more disposed to conspiracies might even go so far as to suggest that the Fed may have even privately telegraphed to those primary dealers its intentions for another round of QE long before the first public suggestions.

In either case, the decline in interest rates may have been nothing more than a scramble for low-risk profit opportunities guaranteed by the Federal Reserve. There is some circumstantial evidence for this, particularly that the bond purchases were skewed mostly to the middle of the yield curve where the Fed mostly operates.

There is more evidence for this theory provided by the counterintuitive rebound in interest rates. If we operate under the assumption that primary dealer banks were loading up on treasuries in order to offload them to the Fed at better prices, the size of the Fed program would be one of the two most important details to the plan (the other being realized price, which would itself be affected by the size).

Many speculated throughout the summer that QE 2.0 would be large. If the primary dealers bought into that theory they would have bought more bonds than if they thought QE 2.0 would be relatively small. If they overbought treasuries and QE came in smaller than they anticipated it stands to reason that they would then rush to sell them at the top price, lest they be left holding bonds where they would be forced to sell into the real market at who knows what price.

This is an issue that has been detailed by ZeroHedge rather extensively. What they have found gives evidence to the “disappointed primary dealer” theory.



To begin with, interest rates at the longer end of the curve (the ten and thirty-year bonds) seemed to inflect and move noticeably higher in early October 2010. Five-year rates found a temporary floor before moving sharply higher toward the end of October. William Dudley, president of the New York Branch of the Federal Reserve hinted that QE 2.0 would only be \$500 billion on October 1¹.

There was a pause in bond selling after October 27, then some heavy buying in the belly of the curve. Not coincidentally, the New York Fed sent out a survey² to the primary dealers *asking their opinion* about what size the new bond-buying program should be. This was a very curious step for the Fed to take; yet no one seemed to even think it was odd. The fact that the Fed took this step publicly only showed the Fed's internal conflict over the matter. It wanted to appear as doing due diligence before beginning a program that was widely criticized, including by high-ranking Fed members. But why survey primary dealers and not include other opinions outside the bond markets?

“What the market wants to hear is that the Fed is going to buy \$1 trillion”, Joseph LaVorgna, chief US economist at Deutsche Bank Securities said on October 28³. To recap, Dudley's speech spooked the dealers as being too little, beginning some pre-QE selling to lock in the high bond prices. Then the survey brings back a little optimism that the Fed is going to listen to Wall Street and buy all the bonds dealers had in inventory, and rates head lower again.

On November 3, the formal announcement of QE 2.0 included only \$600 billion for a duration of six months. It immediately sent rates across the freely traded part of the curve (the short end is pegged) sharply higher, particularly in the belly of the curve.

Selling was acute throughout November and early December, and then tapered off suddenly. ZeroHedge's findings may

explain the change in selling pressure while verifying this account of events. To get the primary dealers to come back to treasuries, the Fed has been allowing those dealers to sell back to the Fed just-auctioned bonds. And if that is not bad enough, the Fed is doing it at unnecessary premiums.

The New York Fed has repeatedly and publicly stated that it seeks to buy bonds at the best prices so that taxpayers are getting the best deal possible. On January 25, through its New York branch Permanent Open Market Operation (POMO) the Fed bought \$7.7 billion in treasuries. But the POMO for the day, presented by ZeroHedge, shows that 71% of the total went to one CUSIP, the five-year bond that was just auctioned off⁴. Worse than that, the price was one of the most expensive relative to the spline (calculated by Morgan Stanley).

The day before that, 51% of the POMO went to one CUSIP, a seven-year note, also just out from auction, and again well rich to the spline⁵. On January 19, \$7 billion of the \$7.7 billion operation (91%) was used to purchase the newly auctioned three-year note. ZeroHedge also notes that the \$7 billion was “half the entire Primary Dealer allocation in the bond auction that was completed January 11 (whose technical issue date was **yesterday**).”⁶ There are many more examples.

It seems the Fed is paying primary dealers for the privilege of holding bonds for a matter of days. Why can't the Fed just go right to the treasury and buy the bonds itself, or directly at auction? Or at least try to pay a fair price? It would save the “taxpayers” money, but it might make the dealers think about reducing their exposure to the sector.

The real point of this story is that the interest rate movements for the past nine months may have reflected nothing more than policy arbitrage. They may have had little attachment to anything fundamental to the real economy. This can fairly be classified



as malinvestment – a small bubble in US Treasury bonds. It would also mean that the Fed missed it in its calculations of the effects of QE 2.0 – the Fed promised lower rates because their models told them to expect that outcome.

It makes perfect sense that if the Fed and mainstream economists (who mostly populate the Fed) ignore inconvenient indications that they would be caught completely unaware by something like a small treasury bubble, or even the dot-com or housing bubbles. Models can be alluringly complex and carefully constructed but that does not guarantee success. Is there any mathematical formula for policy arbitrage in the bond market?

Chairman Bernanke promised QE 2.0 would reduce interest rates. It has not. The best case anyone could make is that it reduced interest rates in the period *prior* to its rollout. But if that was what the Fed expected to happen (because its models predicted it) Bernanke would have said that QE 2.0 *did* reduce interest rates, past tense.

With questions mounting over whether the Fed has lost control over the yield curve (a possibility we raised in March 2010) Vice Chair Janet Yellen rolled out new evidence that *proves* monetary policy is working. She made the claim:

“That path of longer-term Treasury yields leads to a significant pickup in real gross domestic product (GDP) growth relative to baseline and generates an increase in nonfarm payroll employment that amounts to roughly 700,000 jobs.”⁷

This claim was based on the Fed paper, “Have We Underestimated the Probability of Hitting the Zero Lower Bound?”⁸ Ms. Yellen also said that simulations presented in that paper (we will refer to it as the “ZLB paper” going forward):

“...indicate that by 2012, the full program of securities purchases will have raised

private payroll employment by about 3 million jobs. Moreover, the simulations suggest that inflation is currently a percentage point higher than would have been the case if the FOMC had never initiated a securities purchases [sic], implying that, in the absence of such purchases, the economy would now be close to deflation”⁹

Ms. Yellen was kind enough to pick the conclusions that most fit her agenda. If she had presented some of the other findings from the paper, including the basis for the results for the “simulations”, the public would have much less faith (close to zero) in her claims of success.

The paper itself is laid out as a blatant attempt to lend credibility to the Fed’s models. It first acknowledges just how bad the models were in predicting the monetary response to the crisis of 2008, if only so that the reader (or the cherry picking summarizer) will make the logical leap that the Fed has learned from its mistakes and *now* has airtight predictive capacity. From the ZLB paper:

“As can be seen, the model prior to the crisis would have viewed the subsequent evolution of real activity and short-term interest rates as extremely improbable, in that actual conditions by 2010 fall far outside the 95 percent confidence band about the late 2007 projection.

“The bottom line of this analysis is that recent events would have been judged very unlikely prior to the crisis, based on analyses using stochastic simulations of a variety of structural and statistical models estimated on U.S. data on conditions over the past several decades.”¹⁰

The biggest problem with the Fed’s economic and monetary policy models is that they are anchored by history. That may seem like a good thing but as we discussed somewhat in our September 2010 Special Report, time series data has notable



limitations. Models based on the recent past will overlook and discount data that does not look like the recent past. If it has not happened recently these models think that it cannot happen at all.

Worse than that, time series models begin to foster economic “laws” that try to validate what is currently occurring as if it will *always* occur. Because the recent past corroborates some generic economic assumption, economists begin to extrapolate that assumption beyond the limitations of the unique conditions of the specific time period.

Current models are based on observations of the past fifty years and are therefore limited to the experiences of the last fifty years. In truth, they are heavily weighted toward experiences during the bubble periods after 1980. When events unfold similar to those of the 1930’s, the models judge them as extremely unlikely, even impossible (as in “housing prices will never decline because they never have”). We called this shortcoming a lack of imagination since policy that is wedded to time series will never be able to make the unscientific leap to actual human interactions, such as panic selling in the repo market. That would be extremely difficult to model using time series data since the repo market’s marginal impact on credit production has grown exponentially in just the past six years.

The ZLB paper confidently declares that since the Fed is now aware of this limitation, it has corrected it:

“Thus, these simulations take account of the information learned over the past three years regarding both the structure of the economy and, most importantly, the incidence of large shocks during this period. Not surprisingly, the predicted probabilities of hitting the ZLB rise in most cases. More interestingly, the probabilities of being stuck at the ZLB for four or more quarters are now nontrivial in the structural models (except for SW) and

sizable in the statistical models. Even so, only the TVP-VAR and GARCH models see more than a very small probability of being stuck at the ZLB for eight consecutive quarters.”¹¹

If you did not read the above quote carefully you might have missed the authors’ slight of hand. In the last sentence the authors’ admit that the models still massively underestimate the probability of a bad, persistent recession. And for the “structural” models the probability of actually getting to the zero lower bound (ZLB) for four quarters only rose to be classified as “nontrivial”. The “improvement” in forecasting power for the statistical models that the authors call “sizable” amounts to going from forecasting a 1% likelihood of being stuck at ZLB for eight quarters to a 3% to 5% probability¹². That’s right, these new and improved models forecast at best a five percent chance that the Fed would hold interest rates at zero for two years. For the record, the Fed *has* held interest rates at zero for more than two years.

So with the less than dramatic improvement in the forecasting ability of these models, they still predict that monetary policy was a complete success because of one unchanging belief: that lower interest rates always and everywhere produce “real activity directly through cost-of-capital effects as well as indirectly through higher wealth and a lower foreign exchange value of the dollar.”¹³

Since each and every model incorporates this basic assumption (they are mostly based on the bubble years, after all) the Fed will always “prove” loose monetary policy will always be successful, even when it isn’t. During periods where no real activity comes from loose monetary policy (2009-10, for instance) the models simply assume that conditions would have been worse without it. Sadly, monetary policy is now touting “saved” jobs, just like the America Recovery and Reinvestment Act of 2009:



“Model simulations suggest that the additional stimulus provided by these purchases is keeping deterioration in labor market conditions from being noticeably worse than it otherwise would be; the asset purchase program may also be keeping the economy from falling into deflation.”¹⁴

To show that this static assumption is so ingrained in mainstream economics that it can be taken to even the most absurd proportions, the Federal Reserve Board published “Oil Shocks and the Zero Bound on Nominal Interest Rates”¹⁵ in September 2010. The key finding of this paper is that:

“...oil price shocks propagate differently when policy rates in the oil importing country are at the zero lower bound. In particular, we show that the zero lower bound constraint tends to diminish rather than amplify the fall in GDP that occurs in response to higher oil prices in normal times when monetary policy is unconstrained by the zero lower bound.”¹⁶

How does this work, exactly?

“The burst of inflation from an oil price increase lowers real interest rates at the ZLB and stimulates the interest-sensitive component of GDP, offsetting the usual contractionary effects. In fact, if the increase in oil prices is gradual, the **persistent rise in inflation can cause a GDP expansion.**”¹⁷ [emphasis added]

The claim here is beyond counterintuitive. The authors are stating that the inflation created by oil price increases pushes real interest rates already at the ZLB into the negative, which would then “crowd in” (their words) investment simply because lower interest rates *always* stimulate economic activity. These negative interest rates are so powerful they supposedly overcome any bad effects of the oil price increases.

We think it is appropriate here to introduce the concept of a zero upper bound (ZUB). The ZUB is the point at which borrowers are so completely tapped out that they cannot borrow any more at *any cost*. Even at negative real interest rates. They may *want* to borrow as much as possible, but because of credit scores, lack of income, mortgage defaults, two years on unemployment that is now running out, etc., they cannot find anyone to lend them money (lending standards tighten). If this population of individuals and businesses is significant enough, then loose monetary policy does absolutely nothing for them, or by extension the real economy. Instead, loose monetary policy fills the liquidity cushion of those that do not really need to borrow, and then goes directly to malinvestment (with the former at a decreasing rate and the latter at an increasing rate).

Basically the ZUB is a place where monetary policy stops working. We can define it as marginal increases in lending/borrowing activity in the real economy (loans for new plants or equipment) that are more than offset by negative consequences of marginal increases in malinvestment (oil & commodity price investment, excess inventory production due only to fear of increased input costs). The ZUB is itself created by misaligned monetary policy.

If we think of malinvestment strictly as asset bubbles then we tend to forget some of the more persistent problems of malinvestment. Price collapse and its attendant consequences, like a panic, are only the most obvious problems created by malinvestment. For an economy to hit the ZUB it is the less obvious side effects that are important.

A good, indirect way to begin to describe those less obvious effects is the recent conundrum surrounding Okun’s Law. This economic “law” in its current form mathematically describes the relationship of GDP and unemployment. For every 2%



drop in output (annually) there is thought to be a corresponding 1% rise in unemployment. Though economists admit this “law” is more a rule of thumb they nonetheless incorporate it fully in their forecasting models (including the models in the ZLB paper). It has created a bit of a stir in the latest recession since unemployment moved significantly higher than what Okun’s Law predicted – leading to embarrassment for the Obama Administration and the Fed over their underestimation of unemployment in response to monetary and fiscal policy.

There has been a bit of a scramble to explain this breakage, especially now that it has failed to hold again as unemployment has barely budged during the recovery while output has increased from its trough. Some have offered the productivity boom of 2009 as an explanation. Another explanation, offered by Justin Wolfers of the New York Times¹⁸, suggests that the problem is with the measurement of output itself. He posits that instead of using GDP as a measure of output a better alternative would be GDI – GDP measures the economy from the expenditure side while GDI measures the economy from the income side. Theoretically the two should be exactly the same but they never agree due to the methodology of estimating individual components (precision?).

Using GDI we see that the recession was indeed worse than if measured by GDP (Chart 1-3). Further, the recovery has not been as “robust” as it has been portrayed by GDP. Using Mr. Wolfers’ calculations for Okun’s Law in Chart 1-4 it is clear that the GDI method aligns the results more closely to the Okun regression line. But we are not at all satisfied that this is the entire explanation.

The New York Times Economix Blog gets to the key problem:

“Inflation-adjusted gross domestic product, for example, fell by 2.4 percent in

2009. Now consider that the *long-term tendency of the economy* is to grow at an annual rate of 2.5 percent. That means that the decline last year was 4.9 percent below normal performance. So, according to Okun’s Law, the unemployment should have gone from 7.4 percent at the start of the year to 9 percent a year later. Instead it was 10 percent in December, and not much lower in January.”¹⁹ [emphasis added]

It assumed that the potential output of the economy is what it has been recently. Given the transformational nature of the economy this seems to be a dangerous assumption, despite the ongoing attempts of economists to adjust these relationships for labor productivity or inflation.

“For starters, in a modern recessionary economy employers are quicker to shed workers and cut back hours than Mr. Okun had imagined, and more likely in an upturn to rely on productivity — squeezing more work from existing employees — than to hire new people to meet rising demand.”²⁰

Again, this explanation is not completely satisfactory. The Economix Blog says that “employers are quicker to shed workers and cut back hours” without offering an explanation of why that is the case. We do not doubt that productivity played an important role and that the recession was probably worse than what GDP measurements showed, but these are incomplete explanations that leave out what we believe is the most important observation.

For us the real answer lies in the lasting long-term ill effects of malinvestment. Instead of envisioning a lawful relationship between economic output (GDP or GDI) and unemployment we can think of a better explanatory relationship predicated on business profitability. For the purposes of this report we define profitability as before-tax net income of non-financial domestic



business (corporate and proprietorships). We also define employment as civilian non-government employment minus financial business. In this way we are only examining the profits of production and service businesses versus the employment those concerns generate. If we begin to explain movements in employment by movements in the profitability of these concerns the effects of malinvestment begin to stand out.

In 1955 business profitability averaged about \$1,900 per worker employed. By 1965 that average increased to about \$2,500, meaning that companies generated about 31% more profits per worker. Labor productivity, measured by the Bureau of Labor Statistics, showed about a 32% increase in worker productivity. This means that nearly all of the increase in profitability came from productivity.

That \$2,500 average stayed nearly the same from 1965 until late in 1971. Labor productivity had increased about 7% but labor's share of GDI had increased from 50.6% to 52.6%. In addition, corporate tax rates rose in the late 1960's. This meant that the positive effects of productivity were delivered to labor and the US Treasury instead of business' bottom lines.

By the end of 1978 the average had grown 87% to over \$4,700, but labor productivity had only grown about 9%. So where did the increase in profit efficiency come from?

For one, labor costs as a percentage of GDI had fallen back from 52.6% to about 49.5%. This meant that workers were receiving less of incremental increases in revenue. This reduction in labor's share of business revenue explains nearly all the increase in profit efficiency.

Through the double dip recessions of 1980 & 1981/82, efficiency fell back all the way to \$4,164 per worker. This happened even though labor costs as a percent of GDI had fallen further to 48.8%. Worker productivity had finished the period slightly

ahead of the 1978 level, but it had decreased during the 1980 recession and then regained some during the 81/82 contraction. So the drop in profit efficiency was a function of businesses keeping workers at the expense of their net incomes. Fortunately for workers (and Okun's Law) this was largely offset by a sharp drop in corporate taxation.

Effective taxation levels in 1978 were running about 44% to 45%, and jumped to as high as 55% heading into the 1980 recession. But by the beginning of 1983 taxation levels had fallen to 33.3%. Since layoffs emerge as a lag to profit declines the decrease in taxation beginning in 1980 cushioned the blow to employment somewhat, while businesses themselves took some of the hit to profit efficiency by keeping workers. This also suggests that businesses are aware of volatile movements in profit efficiencies and take time to respond to the most extreme movements until a clear trend is established or convincingly reversed.

From 1983 through 1989 profit efficiency increased from the \$4,164 level to \$6,660 per worker, a 60% jump. Labor productivity had increased 15.5% but labor's share of GDI continued to fall, to 47.6%. The low tax rates after the 1982 recession continued until 1986 and then only increased modestly. Compared to previous boom periods, effective tax rates were significantly lower.

This combination of reduced taxation and labor costs explains nearly all the increase in profit efficiency throughout the remainder of the bubble period (there are some minor adjustments for other factors). By the third quarter of 2006 profitability per worker was just below \$20,000. Labor's share of GDI had fallen to a low of 44.37%. Effective tax rates had fallen below 35% for the entire period between 1998 and 2006.

During the entire bubble period (going back to 1971) taxation was certainly an important factor but marginal profitability was far more a function of labor's willingness to



forego a constant proportion of marginal revenue. From 1988 through 2006 it explains 77% of the variation. The question is why would labor, in the aggregate, be so willing to give up wage income?

The easy answer is outsourcing employment overseas resulting in greater competition among labor pools. Certainly this played a role, especially in manufacturing, but manufacturing's share of the labor force (and economy) has been consistently shrinking. And the jobs that did leave tended to be lower income jobs, on an apples-to-apples basis. In the aggregate, those manual labor-intensive jobs that left were often replaced by service sector jobs that offered higher average pay (health care, law offices, and especially financiers – even though we have excluded them for this survey) and required higher functional labor skill.

Another factor certainly has to be the increase in importance of non-wage benefits, particularly health insurance. There is little doubt that many workers give up wages for good health insurance benefits, but this is a relatively new phenomenon, mostly limited to the 2000's.

In our opinion, the largest factor for labor foregoing wage income is the increase in spending power due to sources outside work: asset income and borrowing growth tied to net worth. Going back to our August 2009 Special Report, we have made the case that the full bubble period radically altered the spending habits of households and businesses. This is shown quite well in Chart 1-2 from the August Report (reprinted as Chart 1-6), beginning in 1975. Spending above wage income, net of taxes and transfers, grew to nearly 20% by 1990, and then to almost 25% just before the malinvestment collapse in 2007. This is also the reason for the collapse in the savings rate.

This data shows that the marginal factor for household spending shifted from earned

income to asset income and then borrowing, bringing consumer spending to its recent peak at 70% of GDP. The massive interest income of the late 1970's and early 1980's allowed workers to maintain spending levels despite stagnating wages and higher unemployment (of course this was not at all uniform, affecting different classes of people differently, rather this was an aggregate change across all income levels). After 1982 interest rates followed consumer inflation lower (inflation was still around, it had shifted into asset prices) so that savers began to favor price assets over income assets. This fueled the growth in net worth that created the appearance of favorable balance sheet conditions, combined with artificially low credit costs, ultimately convincing households to borrow and borrow and borrow.

Workers that received very visible benefits from the marginal expansion of purchasing power due to growth in asset prices were much less likely to agitate for higher wages or even search for alternate employment opportunities. The 1990's personified this tradeoff as workers were more than content to trade wages for access to 401(k)'s, especially if the company matched a small portion of contributions, or for stock options tied to profit sharing.

The last leg down in wage income came during the housing bubble. Since housing prices affected nearly everyone and credit was so available, and seemingly so cheap, the creation of artificial net worth and cheap credit made the need for wage growth a secondary or even tertiary concern.

This bubble period of malinvestment left households saddled with too much debt if viewed from the relative purchasing power of wages alone. Is it any wonder that the Fed wants to restart the bubble to attempt to rebirth consumers' net worth-based purchasing habits? To allow the economy to return to a wage-based foundation of spending and borrowing would mean a long-term correction that would require still



higher unemployment and even more reductions in economic activity.

The fact that households find themselves now impervious to monetary designs is entirely due to misaligned monetary policy – the Fed has pushed households into the ZUB by enticing them to give up wage shares in exchange for paper “wealth”. By extension, this situation applies to small businesses and even small corporations that are not already liquid. But none of this malinvestment/asset inflation makes its way into those Fed models. Therefore the Fed continues to believe that lower interest rates *always* stimulate the real economy, and credit expansion that leads to rising asset prices is *always* good. Instead of rethinking these basic dynamics it prefers to ponder the mysterious demise of Okun’s Law, choosing pseudo-scientific theory to empirical reality.

The drop in employment is really not a surprise if you look at it through the lens of profitability (Chart 1-7). But perhaps the biggest damage to the long-term prospects of the economy is what should have happened after the dot-com bust (or, unfortunately, after earlier bubbles). Had there been no additional bubble from that point on, the loss of marginal spending

power from asset prices would have pushed labor back toward earned income. In doing so it would have forced business to innovate while spending more effort and capital on *improving production productivity* as opposed to *financial productivity*. Instead of focusing on stock buybacks and merger mania, or lobbying for more targeted tax cuts and competition-killing legislation, perhaps businesses would have been expanding their capital stock (including R&D) and focusing on being more productive in the real economy. At the same time those long-term economic positives were germinating, households could have deleveraged while they still had a balance sheet in decent shape – before borrowing trillions on asset prices that would disappear in the collapse.

The Fed has formulas, elegant models and enough of a scientific façade to keep on believing that the same answers will work. And should it all end one more time in inflationary ruin, we can take comfort that the Fed’s will develop still newer models that will incorporate that next unforeseen crash. It is possible that eventually those models will work, but not until we have seen every form of collapse imaginable occurring in a single time series.

April 6, 2010 – Rates move higher after a series of “bad” treasury auctions, then dramatically reverse.
August 26 – Bernanke’s speech at Jackson Hole
October 1 – Dudley’s speech
October 27 – Fed’s primary dealer survey
November 3 – QE 2.0 announced at \$600 billion
December 6 – selling pressure eases for unknown reasons, tax cut compromise should have increased default risk and “growth assumptions”, both would suggest higher yields.

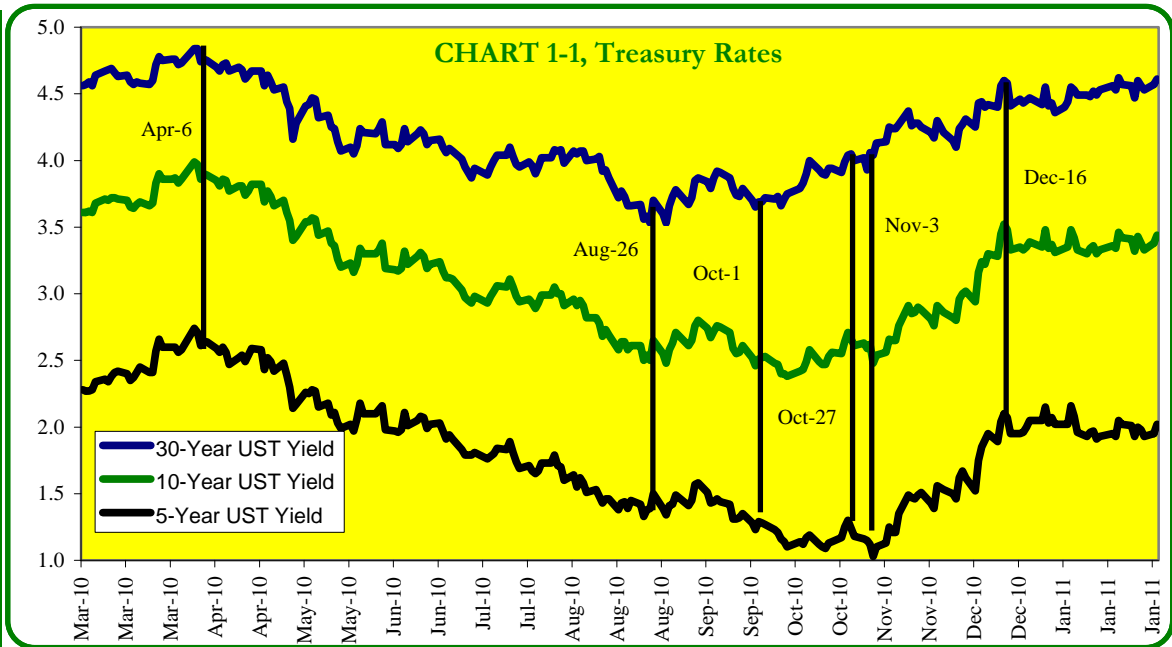
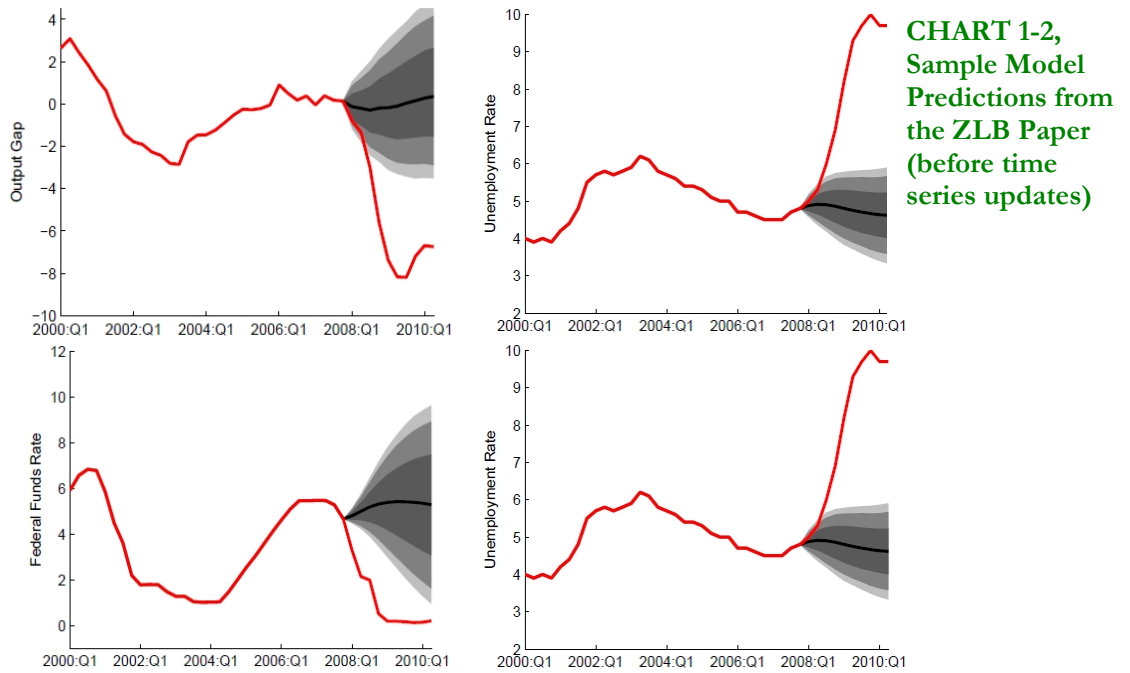
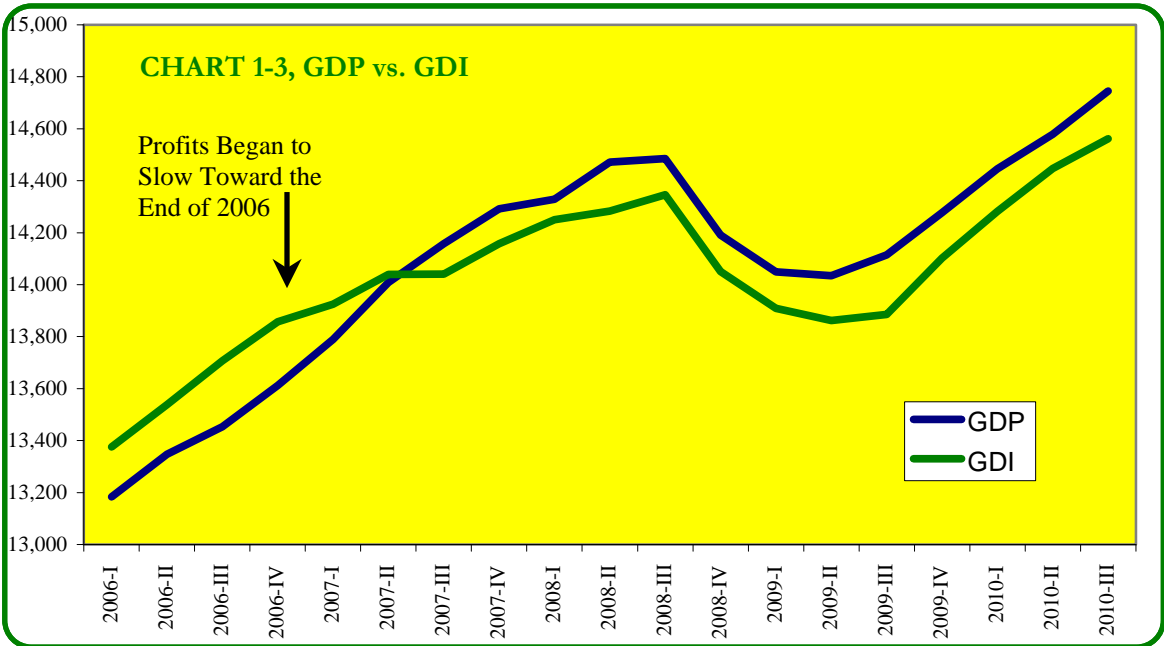




Chart 1-2 shows a sampling of just how bad the Fed's models were. Not only did they miss the recession, they were completely unaware of any trouble brewing. These models were the reason why Bernanke and the Fed were so confident from late 2007 all the way until the panic completely surprised them. It also demolishes the false confidence they have today since these same models have only minimally increased their predictive powers.



GDI shows the recession from a different perspective. It was slightly worse than if measured by GDP.



These charts are reprinted from the Freakonomics Blog at the New York Times, demonstrating Justin Wolfers' theory. Clearly using GDI is a better fit for Okun's Law, but the worst of the unemployment still exhibits significant error to the regression line. The entire regression itself contains too much error, in our opinion, to be used in any sort of model.

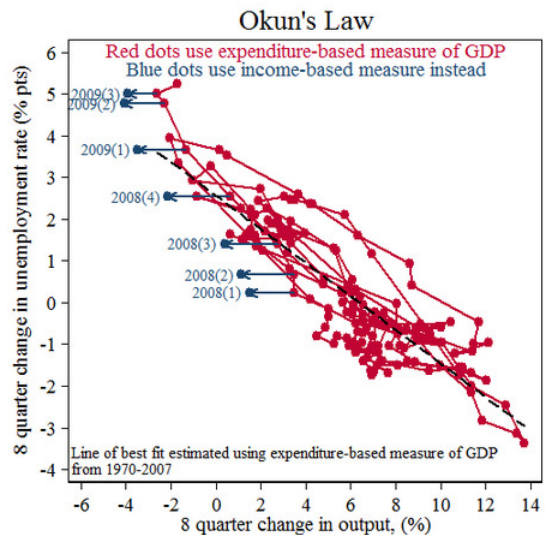
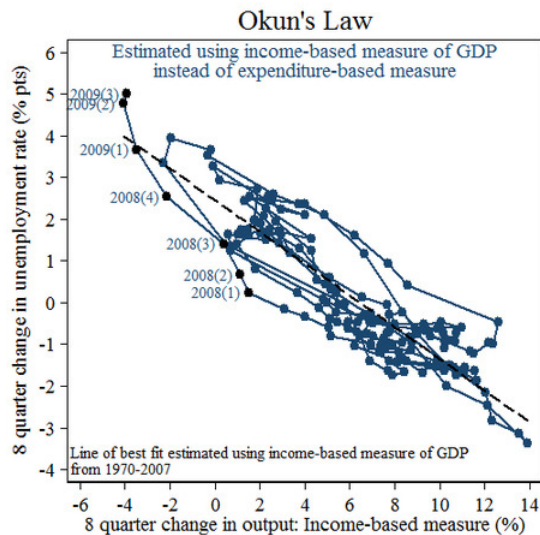
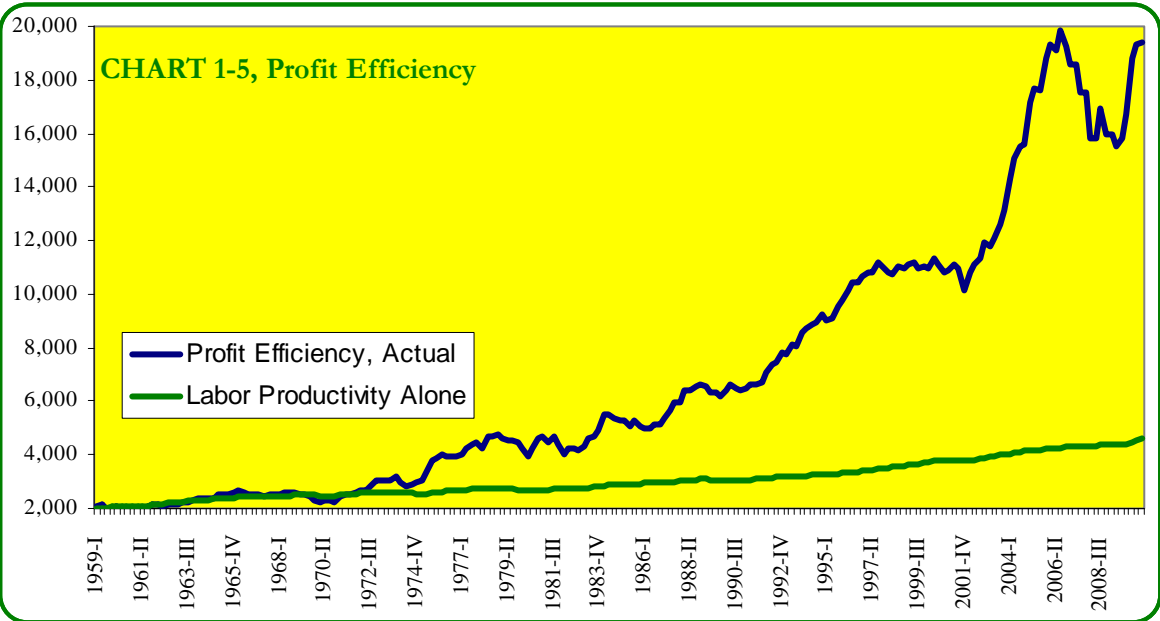
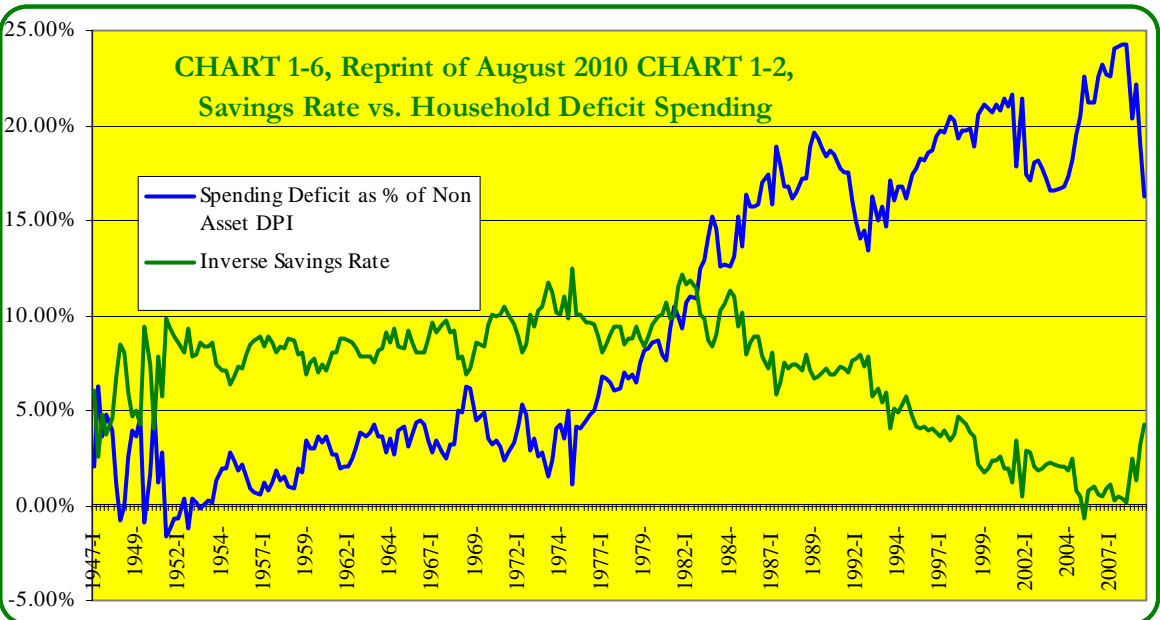




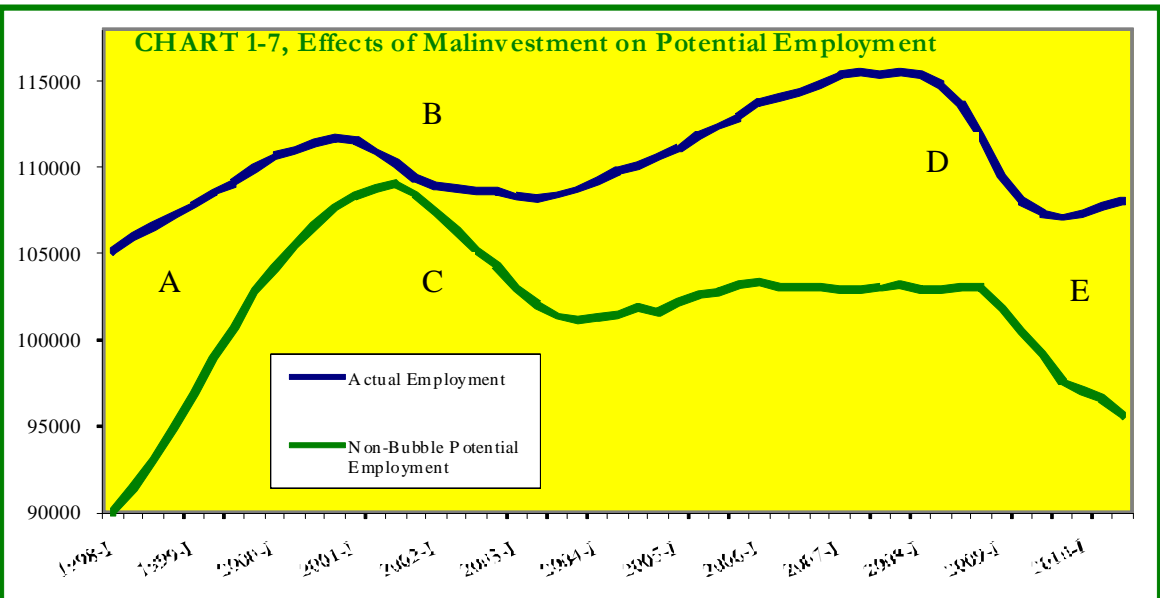
Chart 1-5 shows that profitability per worker has grown exponentially above simple labor productivity. This demonstrates the power of inflationary money, especially since most of that growth is due to labor foregoing a constant share of revenue. Notice that the pre-1970 labor productivity matches profit efficiency well. This chart is one way to measure inflation in all its forms.



Reprinted from August 2010, this shows the effects of inflation on household spending patterns. The increase in spending above earned income is due to inflationary money, and explains much of why labor was willing to forego wage income – it was not needed to maintain spending levels.



A – Businesses absorb some of the costs of labor as profitability declines in the last stages of the dot-com bubble.
B – The recession should have been worse.
C – The new bubble re-established the gap of actual vs. potential.
D – Profitability sunk quickly and took employment with it. Since bubble dynamics had receded actual employment attempted to return to potential.
E – The new bubble in profit efficiency as taxes and labor costs have dwindled again.





Part 2 The End Is Nearer

Economic prosperity earned through real productivity is the only way to long-term, stable growth. The stability generated throughout the bubble period was nothing more than an illusion. Central banks today believe unshakably in two ideas. The first is, again, that low interest rates *always* increase economic activity. The second is that deflation is *always* bad. As we have seen, the veneer of science generates a lot of absolutes.

In speaking about the mysterious depression of 1873-79, Murray Rothbard²¹ succinctly sums up this second absolute:

“Indeed [prices] fell from the end of the Civil War until 1879. Friedman and Schwartz estimated that prices in general fell from 1869 to 1879 by 3.8 percent per annum. Unfortunately, most historians and economists are conditioned to believe that steadily and sharply falling prices *must* result in depression: hence their amazement at the obvious prosperity and economic growth during this era. For they have overlooked the fact that in the natural course of events, when government and the banking system do not increase the money supply very rapidly, freemarket capitalism will result in an increase of production and economic growth so great as to swamp the increase of money supply. Prices will fall, and the consequences will be not depression or stagnation, but prosperity (since costs are falling, too) economic growth, and the spread of the increased living standard to all the consumers.

“It might well be that the major effect of the panic of 1873 was, not to initiate a great depression, but to cause bankruptcies in overinflated banks and in railroads riding on the tide of vast government subsidy and bank speculation.”²²

For mainstream economists deflation is synonymous with depression. Certainly the last depression has left such an impression. Much of this fear, particularly as applied to this crisis, is based on what is called Fisher’s Paradox.

Published in 1933 in the Fed’s *Econometrica*²³ circular, Irving Fisher point-by-point deduced the logical string of events that led to the economic calamity of the Great Depression. He boiled down the outsized trouble to a combination of over-indebtedness and deflation. Fisher was sure that it was a combination of the two that produced the worst results, and that each by themselves would result in something more akin to cyclical recessions.

He stated his paradox as:

“...if the over-indebtedness with which we started was great enough, the liquidations of debts cannot keep up with the fall of prices which it causes. In that case, the liquidation defeats itself. While it diminishes the number of dollars owed, it may not do so as fast as it increases the value of each dollar owed. Then, *the very effort of individuals to less their burden increases it, because the mass effect of the stampede to liquidate in swelling each dollar owed.* Then we have the great paradox which, I submit, is the chief secret of most, if not all, great depressions: *the more the debtors pay, the more they owe.* The more the economic boat tips, the more it tends to tip. It is not tending to right itself, but is capsizing.”²⁴ [emphasis in original]

In the case of the US in 2007, the over-indebtedness was readily apparent. But until October 2008 the Fed was still more worried about inflation than deflation.

We wrote in our June 2010 Special Report:



“Rather than create enough reserves to satisfy the ongoing demand for funds in the repo markets, the Fed, knowing that the amount of new cash needed was huge, was too afraid of the ramifications for inflation expectations if it responded radically. In fact, the Fed had removed liquidity in mid-September [2008], conducting \$50 billion in reverse repurchases (transactions that take cash out of the banking system).

“The Fed was sterilizing its liquidity actions, taking liquidity away from where it was most needed. The Fed, worried about inflation and incorrectly diagnosing the area of illiquidity, astoundingly *completely shut down* its short-term *and* long-term repo programs.”²⁵

The Fed waited until December 2008 before finally radically altering its stance to improve liquidity conditions, after both incarnations of TARP failed to stem the tide of liquidations and panic in the credit markets. It was the persistent liquidations that had them worried about falling into Fisher’s Paradox.

The fears over deflation have not subsided as evidenced by the ongoing monetary expansion. Bernanke has stated as recently as October 2010 that, “At current rates of inflation, the constraint imposed by the zero lower bound on nominal interest rates is too tight” and the “risk of deflation is higher than desirable.”²⁶ Two years after the liquidations he is still concerned about Fisher.

There is still the question of whether or not the liquidation event was equivalent to, or would have led to, Fisherian deflation. Fisher himself defined deflation, as many economists do today, as a “dollar disease”. Deflation is not really just a decline in general or specific price levels, rather it is a function of hyperactive demand for usable currency over illiquid assets.

In the case of the Panic of 2008, the shadow credit market, conducting leverage business in the repo market had become *the* marginal source of credit production based on the premise that securitized loans were what leverage lenders thought they were. They were liquid as long as they were thought to be AAA-rated. Once lenders began to question that assumption they realized that the haircut regime of the day was not strong enough to protect them against potential negative price movements in the collateral they took, even at overnight loan intervals.

The liquidations that began the panic were a result of an increase in those haircuts. Borrowers had leveraged themselves to their maximum, as they often do at cyclical highs, and the haircut change forced them into selling whatever they could to meet the new regime of collateral requirements. In this important regard, the liquidations in the shadow market were not due to a hyperactive demand for currency, they were due to a hyperactive demand for more solid collateral. The frenzied buying of US Treasuries was the short-term solution.

Of course this liquidation had all sorts of nasty macroeconomic consequences, leading to a contraction in available credit for businesses and individuals, and then a nasty economic contraction. But nasty contractions do not necessarily lead to a “dollar disease”. Even Fisher admitted that the disease of over-indebtedness can lead to economic declines independent of the deflationary paradox.

In December 2008, before the Fed abandoned its inflationary fears for ZIRP (zero interest rate policy), there was no evidence that dollars were scarce anywhere but European banks. What made the Great Depression so bad was that individuals had to sell personal possessions to obtain enough currency to buy food and necessities. In doing so, the liquidations of personal assets reduced the value of all produced goods. Even during the worst days of the crisis, in March 2009, there was nothing of this kind



brewing. The nasty liquidation-driven deflation was entirely contained in assets – the malinvestment-driven *asset* inflation was reversing.

For households and businesses the loss of purchasing power through net worth declines and lost credit never endangered their access to currency, it only endangered income and purchasing power. There was never a danger that a widespread portion of the population would have to sell their furniture and their vehicles just to buy food and pay the rent (especially since many began to choose the option of not paying for housing at all).

If this was the case, then what Murray Rothbard wrote about the true nature of central banks was exactly correct. After the Panic of 1893 a new cry arose from the banking syndicates, that money was just too inelastic in times of crisis. Every time there was a banking crisis there was a parallel, desperate run for currency (deflation). Under the gold standard, gold would flow out of the country and reduce liquidity when liquidity was needed most (in the modern economic vernacular this would be called procyclical). A central bank would be instituted to ensure the demand on banks for currency could and would be met at all times, especially during a crisis.

This sounds like an extremely reasonable premise, and avoiding banking panics sounds like a really good thing. But this completely ignores the reason for the banking panics in the first place. By blaming the elasticity of currency for their troubles, the banks were really shifting blame. Panics were nothing more than the corrective mechanism for inflationary excesses during loose money periods. The elasticity of money was the means by which banks were punished for bad loan decisions – they failed. So creating the central bank to change the elasticity equation was really about avoiding failure, and therefore not being forced to take losses on bad business decisions. It is certainly true that good

banks failed along with the bad, but is it better to save every bank, good and bad, or to work toward avoiding a crisis in the first place?

Bringing this argument forward to today, would it have been better to avoid the dot-com and housing bubbles altogether then to be forced to save bad banks with good? Of course the answer is yes. But when it is too late the only two options left are to let the inflationary excesses burn off or try to restore them in the hopes of maintaining the inflationary level of activity (in both the real economy and in price action).

So the Fed's actions in 2009/10 have to be seen as a choice of one of those two options. We clearly believe that it would have been better to allow the inflationary excesses to dissipate as creative destruction would have befallen the economy. In doing so, a new foundation for expansion could have been laid with market discipline at its core and a system of intermediation tailored to meeting the needs of real economic transactions instead of generating price action.

Instead, the Fed chose the latter option (as depicted in Chart 1-7, the significant divergence between actual employment and the non-bubble alternative). This is why this debate is about the role of money in the economy, and it brings up perhaps the most important question for 2011. Is creating inflation to forestall deflation the same as not having deflation?

We think the answer is a resounding no, an extension of Fisher's Paradox being the reason for that conclusion. The Fed is indeed experimenting with monetary policy to see if it can create the exact conditions where there are no deflationary pressures, as Bernanke himself said.

We showcased the Fed's own words in Part 1 to demonstrate that it is intentionally trying to create negative interest rates. It has even become comfortable with rising oil prices, since that will add inflationary



pressures and supposedly stimulate the interest rate sensitive section of the economy. But what about the parts of the economy that are not interest rate sensitive? What if inflationary pressures combine to create a condition of rising interest rates *and* lower discretionary spending for households?

If that were to take place, it seems likely that the rate of mortgage delinquencies would once again rise as more marginal borrowers that just made it through 2008-10 finally succumb to fiscal reality. This would probably deflate home prices at an even faster rate than they are currently sinking (or maybe that is why they are currently sinking again), reducing even further the pool of potential homebuyers while swelling even more the ranks of delinquencies. The downward spiral of home prices would destroy any wealth effect from stocks, reducing consumers' propensity to spend. Credit card delinquencies would also rise. This, of course, would force banks to return to higher levels of net chargeoffs that would cut into already declining financial revenues. The shaky banks would be pressured to raise capital and the whole process would be, out of Mr. Bernanke's worst nightmare, the same type of deflationary pressures he is so trying so hard to avoid right now.

The more Bernanke creates inflation in the real economy, the more he creates deflation in price assets. The more the Fed tries to right the ship, the more it tends to capsize – Fisher's paradox extended.

Of course the Fed economists will counter that there will be all sorts of new jobs created by these inflationary pressures – remember the 3 million jobs Ms. Yellen had "evidence" of. It will be the very first time in history that inflation has created jobs, but is more likely that those 3 million jobs will be forever lost with the stimulus bill's 3 million. The Fed is desperately counting on new jobs at exactly the right time to bring new income sources that will absorb the rising costs of food and energy.

The Fed never really defines what the interest rate sensitive part of the economy exactly is (and we know how tricky they are with definitions) so we can only assume they mean that businesses will borrow more to invest in growth projects, hiring more workers, and that consumers will borrow more to spend, validating those businesses' commitments to investing. This sounds nice, but why would businesses invest now when there is an immense amount of spare capacity leftover from the housing bubble? It seems far more likely that any new investment by businesses will be the same bubble-type investments, such as stock buybacks or mergers.

Even if the Fed is right that businesses will invest and create jobs, there is little chance enough jobs will be created fast enough to offset the inflationary damage. Bernanke himself has said on numerous occasions that: 1. The economy is not moving fast enough to bring down unemployment, and 2. It will take many, many years to return to 2007 levels.

Much has been made recently over the increase in Commercial & Industrial loans at US banks. Since November there has been an increase of about \$20 billion loans for businesses. Even if this does signal a rebound in credit for business, it was easily overcome by the \$22 billion reduction in commercial real estate and construction loans (which would be more indicative of physical investment) and the \$48 billion reduction in consumer credit (who are being counted on to justify business expansion).

With so much spare capacity in physical capital stock and the labor market, the crux of the extension of Fisher's paradox is that any new money will likely continue to accrue to malinvestment. If the ZUB holds (and it has now for more than two years) this effort to create demand through interest rates will end up as the same bubble system of inflation.



So can this new bubble of malinvestment continue for six years like the last one?

There is absolutely no way for that to happen. The type of malinvestment during the housing bubble generated enough leakage into the real economy through construction and real estate jobs. Plus the wealth effect of rising housing prices worked magic on consumer spending levels (leading to the negative savings rate). This time, malinvestment is accruing directly to commodity prices and foreign investments. The US is once again exporting inflation due to the dollar's reserve currency status. In other words, where surplus malinvestment dollars went almost exclusively to asset inflation in 2002-06 they are going almost exclusively to consumer inflation-generating investments in 2010/11.

The nasty effects have already surfaced in the fourth quarter 2010 GDP report. It seemed that economic growth accelerated over the third quarter but that appearance is

especially deceiving. For one, the inventory accumulation took a massive pause, subtracting 3.7% from growth. We hinted at this in our December newsletter after getting the final reading on third quarter GDP. Corporate profits had barely grown in that quarter, and more importantly, aggregate cash flow from operations fell sharply. The combination of inventory accumulation, lackluster demand, and inflationary input costs are not good for business health. A drop in the growth of inventory accumulation was entirely expected as the hit to cash flow from holding inventory rose.

We say that there was lackluster demand, but the increase in personal consumption expenditures rose 4.4% in Q4, greater than the 2.4% rate in Q3. But PCE is not the only indicator of demand. Real gross domestic purchases (total purchases by US residents wherever produced) *fell* by 0.3% in Q4 after growing 4.2% in Q3. That is, total buying activity in the United States declined in the fourth quarter. Actually total dollar volume of buying activity increased, real volume fell. In other words, the United States paid more dollars on the whole to get less stuff. I believe that is a fairly good description of inflation.

The reason for the decline was a sharp drop in the purchases of imported goods, -13.6%. Again, this seems to be a positive for the domestic economy, but the reason for the drop was a massive 22% increase in the prices of imports, i.e., import inflation. We warned of this result in our November 2010 Special Report, particularly as the Fed saw/sees a weaker dollar as advantageous:

“Unfortunately, the unskilled Chinese laborers have little use for American financial innovation and tourism opportunities. Instead, changing the exchange equation will make Chinese goods more expensive without creating a marketplace for US goods. Since there is little competition for those Chinese goods, that expense will end up as import inflation felt by US households.”²⁷

A few months ago no one would even admit inflation was occurring. Now that it is almost universally acknowledged there is a scramble to find an explanation that does not involve dollars and money printing.

Conveniently, the drought and fires in Russia have provided just such an excuse. The riots in Tunisia and Egypt are about food prices that have certainly been affected by the short supply when Russia halted all grain exports.

Sounds reasonable, but how does Russian grain affect the price of Brent Sea Crude? Or Cocoa from the Ivory Coast? Or rice farming in America? The flooding in Australia is another nice scapegoat, but that may only explain some of the movement in coal and steel prices.

The increase in rice prices, as pointed out by ZeroHedge, is due to far less acreage being devoted to rice farming – more for corn and soybeans. Not coincidentally, the prices of corn and soybeans are affected by the money printing, so the inflation in one commodity leads to inflation in another.



The Baltic Dry Index as well as other shipping indices, continue to show a deterioration (Chart 2-1). The falloff in trade coincides with inflation felt outside the US, and continues to get worse.

With this in mind, and knowing that Egypt, Tunisia and several other countries have experienced food riots, is there enough room for the Fed to propagate another bubble for multiple years? We know that China has seen so much inflation recently that they are instituting wage increases and price controls in many urban areas while trying (and not always succeeding) to limit credit growth. These credit-braking activities have squeezed short-term liquidity in China so much that it has all but vanished (see SHIBOR rates on Chart 2-2²⁸).

It seems that the entire world is concerned about inflation, except at Federal Reserve

HQ. Even the head of the ECB expressed strong fears over rising inflation levels in the Eurozone, despite a glut of spare capacity in the whole of Europe. Perhaps he noted the 12% increase in German import prices for December (a 29-year high) that confirms the US reading. Or maybe it was the “surprise” contraction in GDP for the UK in Q4.

Clearly the Europeans, Chinese, Africans, etc., are worried about inflation right now, and may not be as patient as the Fed would like. Those closest to the margins do not have the luxury of waiting for jobs to be conjured by rising stock prices. At least Americans don’t have to suffer the *general* increase in price levels, only the *specific* increases in prices of the things they need most. But they will only suffer them for so long and it will be something far less than six years.

The indices to the right are:
BDI – Baltic Dry
BCI – Baltic Capesize
BPI – Baltic Panamax
BSI – Baltic Supermax

After rebounding in the summer of 2010, the shippers are again seeing pronounced weakness. These prices confirm the weakness in US imports that began in Q3 2010.

Source: *Navigate Magazine*

Chinese short-term liquidity is non-existent. Some have offered the Chinese New Year explanation but that does not explain the immense movements. Inflation has gotten out of hand in China and authorities are trying to drain money.

Source: *ZeroHedge.com*

02/02/10 – 01/02/11

CHART 2-1, Shipping Indices



CHART 2-2, Short-Term Chinese Interest Rates





Part 3 Will Bernanke Equal Weimar?

Ever since the housing bubble burst this crisis has been a monetary trap. So much economic growth and purchasing power was tied to malinvestment that it was not really possible to rebuild the world as it was. Yet we see time and again the same policies reapplied that created the disaster in the first place.

The Fed, one hundred years after the first secret insider meeting to plan its organization and execution, is still trying to make sure there is elasticity in the money supply. The sins of the inflationary lead up are left intact because economists think that they have enough scientific precision to manage the whole of the economy, an obsession that dates back a long time. Rothbard notes:

“For a decade, Herbert Hoover had urged that the United States break its age-old policy of not intervening in cyclical recessions. During the postwar 1920–1921 recession, Hoover, as secretary of commerce, had unsuccessfully urged President Harding to intervene massively in the recession, to ‘do something’ to cure the depression, in particular to expand credit and to engage in a massive public-works program. Although the United States got out of the recession on its own, without massive intervention, Hoover vowed that next time it would be different. In late 1928, after he was elected president, Hoover presented a public works scheme, the ‘Hoover Plan’ for ‘permanent prosperity,’ for a pact to ‘outlaw depression,’ to the Conference of Governors.”²⁹

There have been four inflationary shocks just in the past forty years. The first two (1970’s stagflation and the Savings & Loan destruction) ended in recessions but no outright depressions. From these two results economists, first and foremost Alan Greenspan, began to believe they had found Hoover’s “permanent prosperity”.

Economists assumed, incorrectly, that the “Great Moderation” of the 1990’s was due to their

monetary machinations. So naturally they made monetary models that reflected their belief. There was lip service paid to the innovation and business investment of the time, but there was believed to be much more power in Greenspan’s briefcase than the whole of Silicon Valley. There was even a debate about whether the massive technological transformation of that decade was even possible without Greenspan’s monetary policy.

The late 1990’s were awash in the rhetoric of a “new normal”, where depressions had been outlawed by the best and the brightest. When the third inflationary collapse hit, the dot-com bust, economists did what their models told them was proper and effective. They inflated credit even more and the recession was extremely mild. So mild, some people today still attribute it to the tragedy of September 11 (even though the recession had nearly ended by that time).

Perhaps because the third inflationary collapse was a slow, drawn out bear market rather than a sharp crash it had so little effect on economists. Certainly, Greenspan had lost some luster (and control of the price of gold) but there was no sea change in monetary or economic thinking. Hoover’s plan was still in place and was still being used.

Some thought has to be given to the role of money in the economy. Perhaps money and credit are *supposed* to be inelastic in a crisis. Maybe that inelasticity is the pressure valve in the inflationary system. Depressions do more than cause bank failures and business bankruptcies, they also wash away mountains of debt accumulated through malinvestment. Instead of banishing depressions to the dustbin of history, economists instead disabled the very mechanism that allows the economy to thrive over the longer-term. By inflating credit, the Fed leaves in place the massive debt that was created during the inflationary boom solely because it fears deflation.



What if after the dot-com bust the Fed followed Harding's policy from the 1921 depression. What if we had a much nastier contraction in 2002, including a bout of deflation. It is likely that at that time, minus a housing bubble, the levels of indebtedness in both the households and business sectors were not great enough to be considered "over-indebted". Fisher's paradox would not have applied. What may have happened was a system-wide reset through deflation. Incomes would have fallen with price levels, as would the dollar. The result (after much consternation and trouble with the other inflationary central banks) would have been a much more competitive labor force, and a greater business focus on real investment. Real estate would still be a place for growth rather than a smoldering, consistent problem.

Perhaps this hypothetical hindsight is a bit simplistic but it was certainly possible. The most unfortunate part of this monetary history was that there was still time to prevent the 2008 nightmare as late as 2003. Would anyone now (outside of mainstream economists) not choose that alternative over the current situation? If our hypothetical would have been worth a try, then why is it any different today? Why is it better to, for the fifth time in forty years, disable creative destruction and return to inflationary credit?

The serious stages of inflationary pressures have already begun and entrench inflationary expectations further every day. The more the Fed commits to monetary easing the more malinvestment occurs in commodities and gets exported. But that clock has begun to tick closer to the end now that the inflation the Fed is exporting has begun to boomerang. This situation is very similar to the early 1970's that helped trigger the oil embargo (the Yom Kippur War was the proximate cause but the idea of embargo began when inflationary dollars started squeezing OPEC members).

Ford's January 28, 2011, earnings release missed expectations by a wide margin (sending the stock 13% lower on the day). The New York Times summed up the miss:

"The company also cited higher manufacturing and commodity costs, a point that concerned some analysts."³⁰

Going back to the GDP report released earlier on the same day as Ford's results, we know that motor vehicle output reduced GDP by the largest amount since the worst days of the crisis – the fourth quarter of 2008. Knowing that there has been a massive build up of motor vehicle inventory since the end of 2009 (especially at GM), lower profit margins due to commodity prices can very well begin to dent GDP growth. If this happens to occur during a quarter where other central banks devalue *their* currencies, the "positive" effects of lower imports to the US will be erased and GDP goes negative (without the +3.44% contribution from reduced imports GDP would have been *negative* in Q4 2010). We expect earnings misses by manufacturers to increase as long as the Fed stays on its current monetary course, as the "prices paid" indices within every manufacturing survey surges.

On the other hand, if the Fed somehow fails to extend monetary policy beyond QE 2.0 we believe we will see a rerun of the summer of 2010. This economy is so dependent on monetary stimulus that when it was removed after March 2010 all hell broke loose. Since the fundamental basis for the economic contraction is still intact, overvalued real estate (including commercial) and lost asset-based purchasing power and credit, there is no reason to believe that the economy can grow on its own. Bernanke and the Fed actually agree with this analysis, admitting that the recovery is not yet "self-sustaining" (we do have to applaud them for using *empirical* results for once).

The monetary trap gets tighter and, unfortunately, the higher prices go the worse the crash becomes. Just as it may have been better to let the system reset in 2002, it may have been much better to let it try to reset again in 2010. Until the mountain of debt tied to overvalued assets is washed away by creative destruction and asset deflation there can never be organic growth. The economy cannot efficiently reallocate scarce resources until the old



inflationary ideas are defunded and destroyed. With the federal government running out of fiscal room to pay off idle labor the noose becomes fatally tight – more 99'ers lose unemployment benefits every week, leaving them with no alternatives.

So how does this end: deflation, stagflation or hyperinflation? It is, in our opinion, still too early to decipher the type of inflationary crash. In reality, all three are still possible, and each one presents different challenges for investors and the economy. In truth, the path we take will be directed by how the Fed views the role of money. We have spent a lot of time and ink complaining about the Federal Reserve and its monetary religion for precisely this reason.

The roots of our inflationary malinvestment can be traced back to well before even Herbert Hoover, back to the Civil War. To pay for war, both the Union and Confederacy issued fiat paper dollars. Both lost value almost as soon as they were issued. The Union also borrowed heavily, relying on Jay Cooke to sell US debt instruments (he was the general subscription agent of the government loans). Cooke made a fortune doing so but realized that his game would be up at the end of the war, particularly if there was an effort to retire the debt.

In early 1865, Cooke published a pamphlet urging the continuation of the federal debt in perpetuity. Cooke stated plainly, “We lay down the proposition that our national debt, made permanent and rightly managed, will be a national blessing.”³¹ To establish this “blessing” the United States only needed to realize that its debt was “wealth”:

“The funded debt of the United States is the addition of three thousand millions of dollars to the previously realized wealth of the nation. It is three thousand millions added to its available active capital. To pay this debt would be to extinguish this capital and to lose this wealth. To extinguish this capital and lose this wealth would be an inconceivably great national misfortune.”³²

How exactly did debt become wealth? Because it had become currency in Cooke’s eyes:

“The retention of our National Debt is necessary as the basis of a system of National Banking. The bonds of the United States, accepted throughout the United States as the highest security, and having a uniform value in every one of the States, are the only real and safe equivalent for gold and silver, and the only available basis for a uniform bank-note currency that shall be money all over the Republic. Commerce demands this uniform currency. Politics requires it. ...There is not now any other basis for this currency, nor can any other be devised, than the Debt of the whole United States.”³³

The transition from hard money backed by gold (and sometimes silver) to fiat Federal Reserve Notes backed by US Treasury Notes and Bonds flowed through Cooke’s business development efforts. Lost in the transition to paper wealth was the entire concept of wealth itself. Cooke stated that paying down the debt would be akin to losing wealth. This notion came from the idea that to pay down debt principal would require an increase in taxation, an increase in the amount of wealth extracted from the productive economy. Therefore the size of the pile of government debt represented potential wealth extraction, and thereby wealth itself.

Wealth was once believed to be the productive capacity of a nation or business, measured intermittently by dollars or currency. Beginning with Cooke, wealth became the amount of paper. Banks were allowed to change the way they did business in the years after the civil war (this period saw another fundamental shift in banking, this time away from state banks toward national banks). The currency they issued had to be convertible into gold or silver before the war. After, they were allowed to maintain gold, silver, or US government debt as reserves for their currency and deposits. Under the new theoretical framework, treasury notes were as good as gold.

Once government debt began to back bank-issued currency the theoretical idea of debt as



wealth became real. And because its supply could be manipulated, the banking cartels were on their way to realizing their dream of inelastic money. The creation of the Federal Reserve System in 1913 was really the last piece of the fiat puzzle, providing both a uniform currency and central control over discount rate mechanisms and gold flows.

It is widely believed that Federal Reserve Notes are backed by the full faith and credit of the US government. But they are really only backed by the bonds they own. If the real value of those bonds is the ability of the US government to pay the interest then there may come a time when taxation has to increase just to pay the interest on the debt. This would begin to set Cooke's transformation in reverse. Even under Jay Cooke's notion of wealth, there was a tangible limitation to the growth of government debt: the ability to pay the interest. If we have to reduce the productive wealth of the nation just to pay the *interest*, then the paper idea of wealth itself has been set back as well.

It is not too hard in 2011 to imagine a situation where the productive economy cannot really afford the increase in confiscation through taxation without itself contracting (wasn't that the debate in December?). In this situation, all the paper wealth would drain itself backward toward the fundamental foundation of production potential. This vicious cycle starts when treasury debt interest costs force an increase in taxation, which reduces economic activity, forcing a further increase in taxation, which reduces economic activity, and so on. This would be the start of hyperinflation. At this point the Fed would have to monetize all the debt and interest payments, and the meaning of the US dollar would be not much greater than zero.

The beginning stages are already set with QE 2.0. The Fed is trying to avoid raising the interest cost of the government's "wealth" precisely because it *would*, in fact, lead to another contraction. At the ZUB low rates do not stimulate the real economy, but rising rates do contract credit and lead to more asset deflation (think about how far housing prices

would fall with another 1-2% increase in mortgage rates). Hyperinflation is another form of "dollar disease", whereby no one wants the currency (deflation is where everyone wants currency). In our globally connected system beset by imbalance, the marginal holders of US assets are foreign. The more the Fed prints money the less those dollar assets are potentially worth at some point in the future. Everyone knows this part of the process, but where it really gets scary is if those foreign holders of dollars and dollar-denominated assets decide that further debt issuance will only lead to higher taxation in the very-near future. Then the inflationary drop in the value of the dollar is joined by a much worse devaluation of the country's productive potential (since paper wealth will have to be extracted in increasing size to meet growing demands for taxation).

This scenario sounds like too much fantasy and hyperbole to really worry about it. Can it really happen?

If the Fed chases government and municipal debt down the rabbit hole it can. The problem with inflation at the ZUB is that it no longer benefits borrowers. Inflation is supposed to help those deep in debt by making their obligations lighter down the road. But that only works if income payments also experience inflation – meaning the amount of dollars to be repaid is fixed while income streams receive more dollars through inflation. At the ZUB, income payments actually fall since the only result from inflationary pressures is malinvestment.

Rising stock prices can increase tax collections at the federal level to help offset debt-carrying costs. But those taxes can also be reduced by lower economic activity. In the case of Q4, a reduction in import activity reduces the amount of import duties collected. In all of 2010, the Federal government collected \$442 billion (-16.7%) less than the CBO estimated³⁴ it would at the beginning of 2010. That is not a small miss and it was due to the lack of recovery despite inflationary monetary policy.

States and local governments find themselves in the same predicaments. Inflation in food and



energy are not going to increase tax revenues (especially sales taxes) because people will buy less and look for cheaper alternatives (see 2008). Without sustained income through job opportunities, individuals will be forced to trade spending on discretionary items for spending on food and energy. Households in the aggregate get *less* income because there is no inflationary increase in jobs while government transfers continually dry up. But it does cost more to live.

Without any beneficial effects from rising prices, even if they are only *specific* prices, the impact on borrowers is actually negative. The federal government runs higher deficits than it thought it would (the CBO increased its combined deficit projections by \$1 trillion for

2011 & 2012 from only a year earlier) and municipalities' struggles ratchet higher. Bailouts are off the table so the Fed is the only one left to respond.

The combination of inflation and no economic growth is supposed to be stagflation. But if we are at the ZUB with over-indebtedness then all recovery scenarios are really predicated on the value of the dollar, or what the Fed's models wants the value of the dollar to become. If that value is too low then foreigners start the hyperinflation process by selling dollar assets, which in turn forces debt service costs higher, meaning more taxation that reduces economic potential. Paper wealth as it has been since Jay Cooke gets redefined.

Conclusions

This has been a rather lengthy examination so we will keep our conclusions short. Part 1 demonstrated flawed monetary theories wrapped in the pretense of science. The combination of the two means that the Fed will allow malinvestment to grow and fester. Just like previous times, the Fed is actually encouraging it. It has given itself the false hope of precision despite its atrocious track record.

We have already seen the imbalances and side effects of malinvestment in the real economy and asset prices. There is little doubt, supported by empirical evidence, that an inflationary bubble is building. The difference between this one and the previous two is the lack of economic activity being generated by them. Since malinvestment is focused on commodity prices, stock prices, and foreign investments there has been relatively little spillover into real economic activity. We will continue to hear from the Fed's side that the recovery is just around the

corner, but it will remain there as long as malinvestment stays in the non-recycling side of the velocity cycle.

The last bubble pushed the economy for six years. There is no chance of that being repeated. The fourth quarter GDP report confirmed that malinvestment is already affecting activity. We described the hyperinflationary scenario in Part 3, but stagflation is just as much a possibility. Stagflation itself is not just high employment and low growth, rather it is a ratcheting cycle of boom and busts. Its defining quality is not high unemployment with rising inflation, though those are symptoms, rather stagflation is an economy that is in a rut it can never seem to get out of. And that rut is monetary – money and credit do not match the needs of the economy. How monetary policy evolves in the next year will determine how the bubble ends, stagflation or hyperinflation, with a torrent of asset deflation.



Endnotes

- ¹ “Fed Action Warranted Unless Outlook Improves”, Cooke and Spicer. Reuters.com, October 1, 2010.
<http://www.reuters.com/article/2010/10/01/us-usa-fed-dudley-idUSTRE6902IB20101001>
- ² “Fed Asks Dealers to Estimate Size, Impact of Debt Purchases,” Christie and Torres. Bloomberg.com, October 28, 2010.
<http://www.bloomberg.com/news/2010-10-28/fed-asks-dealers-to-estimate-size-impact-of-debt-purchases.html>
- ³ *ibid.*
- ⁴ “POMO Results: PM6 All The Way, 71.1% Of Total,” Tyler Durden. ZeroHedge.com, January 25, 2011.
<http://www.zerohedge.com/article/pomo-results-pm6-all-way-711-total>
- ⁵ “Today’s Edition of the FRBNY’s ‘Flip That Bond’ Criminal Reality Show...”, Tyler Durden. ZeroHedge.com, January 24, 2011.
<http://www.zerohedge.com/article/todays-edition-frbnys-flip-bond-criminal-reality-show-now-books-primary-dealers-continue-chu>
- ⁶ “Blatant Treasury Churn At the Fed: Entire POMO Consists of Just Auctioned Off 3 Year...”, Tyler Durden. ZeroHedge.com, January 19, 2011.
<http://www.zerohedge.com/article/blatant-treasury-churn-fed-entire-pomo-consists-just-auctioned-3-year-frbny-launches-flip-bo>
- ⁷ Federal Reserve Board Vice Chair Janet Yellen, Speech at The Brimmer Policy Forum, Allied Social Science Associations Annual Meeting. January 8, 2011.
<http://www.federalreserve.gov/newsevents/speech/yellen20110108a.htm>
- ⁸ “Have We Underestimated the Likelihood and Severity of Zero Lower Bound Events?”, Chung, Laforte, et al. Federal Reserve Bank of San Francisco Working Paper Series, January 2011.
<http://www.frbsf.org/publications/economics/papers/2011/wp11-01bk.pdf>
- ⁹ Yellen Speech, see #7.
- ¹⁰ ZLB Paper, Pages 11 & 12.
- ¹¹ *Ibid*, Page 12.
- ¹² *Ibid*, Table 2, Page 38.
- ¹³ *Ibid*, Page 19.
- ¹⁴ *Ibid*, Page 32.
- ¹⁵ “Oil Shocks and the Zero Bound on Nominal Interest Rates”, Bodenstein, Guerrieri and Gust. Board of Governors of The Federal Reserve System, International Finance Discussion Papers, September 2010.
<http://www.federalreserve.gov/pubs/ifdp/2010/1009/ifdp1009.pdf>
- ¹⁶ *Ibid*, Page 3.
- ¹⁷ *Ibid*, Page 1.
- ¹⁸ “Is Okun’s Law Really Broken?”, Justin Wolfers. New York Times, Freakonomics Blog, March 1, 2010.
<http://freakonomics.blogs.nytimes.com/2010/03/01/is-okuns-law-really-broken/>
- ¹⁹ “A Broken Economic Law”, Louis Uchitelle. New York Times Economix Blog, February 22, 2010.
<http://economix.blogs.nytimes.com/2010/02/22/a-broken-economic-law/>
- ²⁰ *Ibid*.
- ²¹ “A History of Money and Banking in the United States: The Colonial Era to World War II”, Murray N. Rothbard. Ludwig von Mises Institute, 2002.
<http://mises.org/books/historyofmoney.pdf>
- ²² *Ibid*, Page 155.
- ²³ “The Debt-Deflation Theory of Great Depressions”, Irving Fisher. *Econometrica*, March 1933. Pages 337-57.
<http://fraser.stlouisfed.org/docs/meltzer/fisdeb33.pdf>
- ²⁴ *Ibid*, Page 344.
- ²⁵ ACM June 2010 Special Report, “Why Quantitative Easing Cannot Work”. June 30, 2010, Pages 9 & 10.
<http://research.acminstitutional.com/Series3-4.html>
- ²⁶ Federal Reserve Board Chair Ben S. Bernanke, Speech at Low-Inflation Environment Conference. October 15, 2010.
<http://www.federalreserve.gov/newsevents/speech/bernanke20101015a.htm>



²⁷ ACM November 2010 Special Report, “A Desperate Fed”. November 16, 2010, Page 19.

<http://research.acminstitutional.com/resources/November+2010+Special+Report.pdf>

²⁸ “Holy SHIBOR Batman, We Have A Snow Problem”, Tyler Durden. ZeroHedge.com, January 25, 2011.

<http://www.zerohedge.com/article/holy-shibor-batman-we-have-snow-problem>

²⁹ Rothbard History of Money, See #21. Pages 272 & 273.

³⁰ “Ford Shares Tumble as Fourth Quarter Misses Forecast”, Nick Bunkley. New York Times, January 28, 2011.

<http://www.nytimes.com/2011/01/29/business/29ford.html?src=twrhp>

³¹ “How Our National Debt May Be A Blessing”, Samuel Wilkeson. Issued by Jay Cooke, M’Laughlin Brothers, Printers, Philadelphia, PA. 1865.

<http://www.archive.org/details/howournationalde00wilkrich>

³² Ibid, Page 6.

³³ Ibid, Page 8.

³⁴ “CBO’s Revised Budget Sees 2011 Deficit Rising By \$500 Billion To \$1.5 Trillion...”, Tyler Durden.

ZeroHedge.com, January 26, 2011.

<http://www.zerohedge.com/article/cbos-revised-budget-sees-2011-deficit-rising-500-billion-15-trillion-4-trillion-deficit-thro>

Atlantic Capital Management of Florida, Inc., is an SEC registered investment advisor. Atlantic Capital's Form ADV, Parts I & II, are available upon request or online at www.adviserinfo.sec.gov. Atlantic Capital's Disclosure Statement is also available upon request. All research and analysis is done by ACM staff. All Special Research Reports are for educational purposes ONLY. These reports do not take into account specific investment criteria of individual clients. All opinions expressed are current opinions as of the date indicated on the reports and may be changed without notice. Information obtained from various sources is believed to be reliable but ACM makes no guarantee of the accuracy or completeness of such information. No investment recommendations are given or implied. Past performance is no guarantee of future results.

© 2011 Atlantic Capital Management.



ATLANTIC CAPITAL MANAGEMENT
ACM INSTITUTIONAL SERVICES

580 VILLAGE BLVD, SUITE 315
WEST PALM BEACH, FL 33409
1 (888) 810-1588

www.acmwealthadvisors.com

www.acminstitutional.com