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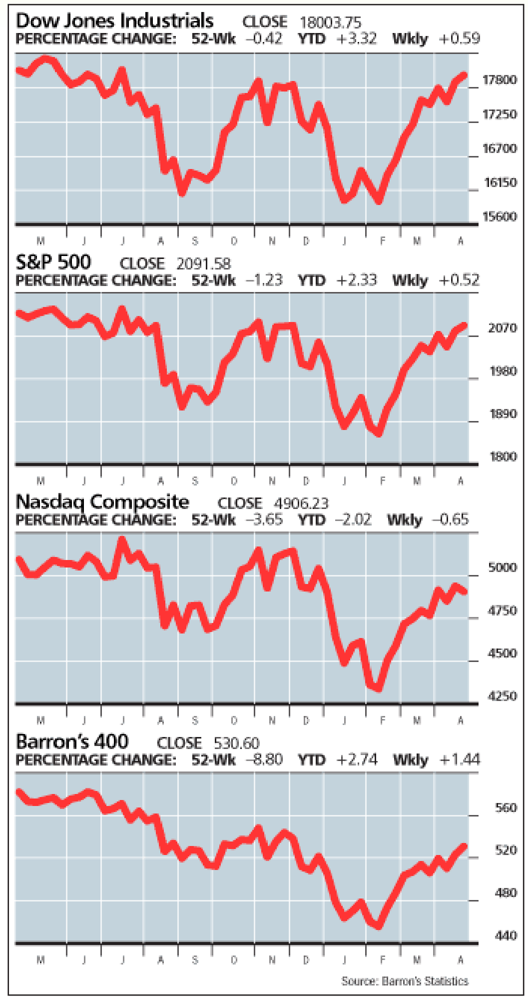

Source: Barron's Statistics April 23, 2016

Today's economic orthodoxy promotes the policies of the late economist John Maynard Keynes.[1] Keynes essentially held that the concepts of neoclassical economics were incorrect; Keynes asserted that free markets would not, over the short to medium term, automatically adjust to provide full employment and economic prosperity. Keynes hypothesized that aggregate demand determined the overall level of economic activity and that inadequate aggregate demand could lead to prolonged periods of high unemployment. In order to mitigate the adverse effects of economic recessions and depressions, Keynes advocated state intervention through fiscal and monetary tools to regulate the boom and bust cycles of economic activity.

The Keynesian prescription to remedy economic maladies, in full bloom today, is to stimulate the economy by each of these measures: "print" more money, enable more debt, and promote spending in the public sector while encouraging consumption in the private sector. Additionally, the Federal Reserve governors would have us believe they can execute these economic adjustments with the same skill as a surgeon wields a scalpel. Notwithstanding the Federal Reserve governors' insinuations, monetary policy is, at best, a crude tool subject to human error. Attempting to regulate a Complex Adaptive System[2] is never a sound idea (leading to all manner of mischief, or worse).

A consensus has emerged that recent Federal Reserve policies has been abundantly unsuccessful in motivating consumers to borrow money and spend – although it appears to have been highly successful in

Footnotes

1. John Maynard Keynes was a British economist, successful investor, and advisor to the U.S. government during the Great Depression.
2. For a refresher of Complex Adaptive Systems (CAS), see the following editions of *Commentary*: April 2009 (Issue #236), December 2012 (Issue #280), and December 2014 (Issue #304).

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encouraging various activities that tend to be speculative. Lowering interest rates and blanketing the economy with liquidity, to encourage consumption by the consumer, lends itself to the adage, "you can lead a horse to water but you cannot force it to drink." While the Central Bank "Put" (formerly the "Greenspan Put"[3]) has provided the impetus for investors to assume greater risks within the financial markets, it appears such policies have failed to exert the same influence in the consumer sectors of the economy.

Hubris and Vanity

The reaction Bob and I have regarding current Federal Reserve policies can be best expressed by the following remark by the late Friedrich August von Hayek,[4] "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design."

Consider the following admonition by Adam Smith in 1776,[5] "The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it."[6] [Sullivan & Serwitz emphasis]

Nearly 200 years later, F.A. Hayek, in his 1974 Nobel Prize acceptance speech, *The Pretense of Knowledge*,[7] echoed Smith's admonition, "If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that in this, as in all other fields where essential complexity of an organized kind prevails [i.e., any Complex Adaptive System], he cannot acquire the full knowledge which would make mastery of the events possible…

"The recognition of the insuperable limits to his knowledge ought indeed to teach the student of society a lesson of humility which should guard him against becoming an accomplice in men's fatal striving to control society – a striving which makes him not only a tyrant over his fellows, but which may well make him the destroyer of a civilization which no brain has designed but which has grown from the free efforts of millions of individuals." [Sullivan & Serwitz emphasis]

Smith and Hayek's central point is that only the arrogant believe they are blessed with sufficient knowledge and wisdom to meddle in a Complex Adaptive System (like an economy).

Money ≠ Wealth

What our political elite, and the economists who are most influential in setting policy, fail to understand is that money in and of itself is not wealth. It has

Footnotes

3. The "Greenspan Put" refers to the monetary policy during the tenure of Alan Greenspan, the former Chairman of the Federal Reserve Board (Fed). The term "put" refers to a put option which is a contractual obligation giving its holder the right to sell an asset at a specific price to a counterparty. During Greenspan's chairmanship, whenever an economic slowdown was perceived, or the stock market fell more than about 20%, the Fed would lower the Fed Funds rate to stimulate the economy. (The evidence suggests these rate cuts were as much politically motivated as any other reason proffered by our political elite.) The Fed's pattern of providing liquidity resulted in the investors' perception of "put protection" on asset prices. Wall Street increasingly believed that in a downturn, or crisis, the Fed would step in and inject liquidity until the problem was resolved. The result of these manipulations was higher stock valuations, narrower credit spreads, and excessive risk taking. Ultimately the "put" served to privatize profits and socialize losses – an antisocial unintended consequence. Today the term frequently implies "moral hazard."
4. Friedrich August von Hayek, who is most frequently identified as F.A. Hayek, was an Austrian and British economist and philosopher who in 1974 was awarded the Nobel Memorial Prize in Economic Sciences. Hayek's most well-known book, *The Road to Serfdom*, has sold over two million copies.
5. Adam Smith was a Scottish philosopher and is frequently cited as the pioneer of modern economic organization. Smith is best known for two classic works: *The Theory of Moral Sentiments* (1759), and *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), which is usually abbreviated as *The Wealth of Nations*. Smith may be best known for his "invisible hand" metaphor which describes unintended social benefits resulting from individuals' self-interested actions.
6. Smith, Adam. *An Inquiry into the Nature and Causes of the Wealth of Nations, see* http://www.gutenberg.org/cache/epub/3300/pg3300.txt
7. For a written transcript of the speech, see http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1974/hayek-lecture.html

no intrinsic value. What money does do is *measure wealth, and provide a mechanism to store wealth*, while simultaneously becoming *a claim on the wealth that a society produces*. Because money serves as a measure and claim on an economy's goods and services, money becomes an extremely efficient tool – serving as a conduit or intermediary – to facilitate commerce and investing (by communicating the prices of countless goods and services). With the advent of money, society was freed from the cumbersome and inefficient process of barter.

Think of the process that money facilitates in the following manner: a farmer may buy a tractor with dollars, for example, but in reality he is using money as a conduit to exchange a certain quantity of his output – wheat, corn, etc. – for this tractor. The same relationship holds true for any other member of society.

With a correct understanding of money, the flaw of the Keynesian economic prescription is revealed: consumers, farmers, and businesses, can purchase goods and services only after producing something others will value. In other words, our political elite and the Keynesian economists have it backwards. They have confused cause and effect: consumption can only follow production. Even for the inheritor who may produce nothing, someone had to first create something of worth – the value of which was effectively stored (as money) for future consumption. It is not possible to consume a good or service until someone has first produced it.

Keynes and his disciples have never demonstrated that consumption can lead to productivity – they have only asserted that consumption precedes production. Keynes famously – and seriously – asserted we could pay people to dig holes and refill them in order to stimulate the economy. Here is Keynes's actual quote, "If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and leave it to private enterprise on well-tried principles of laissez-faire to dig the notes up again (the right to do so being obtained, of course, by tendering for leases of the note-bearing territory), there need be no more unemployment and, with the help of the repercussions, the real income of the community, and its capital wealth also, would probably become a good deal greater than it actually is. It would, indeed, be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing."[8] I demur.

In 1962, the late economist Milton Friedman had this to say about Keynesian remedies: "I know of no… coherent or organized body of evidence justifying them…. [They] cannot be demonstrated to be true by logical considerations alone, [and] have never been documented by empirical evidence…"[9]

The following quote is from Austrian Economist, Patrick Barron, "Keynesian aggregate demand theory is nothing more than a justification for counterfeiting. It is a theory of capital consumption and ignores the irrefutable fact that production is required prior to consumption. Central bank credit expansion is the best example of the Keynesian disregard for the inevitable consequences of violating Say's Law.[[10]] Money certificates are cheap to produce. Book entry credit is manufactured at the click of a computer mouse and is, therefore, essentially costless. So, receivers of new money get something for nothing [at the expense of other members of society].

The consequence of this violation of Say's Law is capital [mal-investment], the opposite of the central bank's goal

Footnotes

8. *The General Theory of Employment* by John Maynard Keynes. http://cas.umkc.edu/economics/people/facultypages/kregel/courses/econ645/winter2011/generaltheory.pdf. Page 85 of this PDF.
9. Friedman, Milton. *Capitalism and Freedom: Fortieth Anniversary Edition*. University of Chicago Press, Copyright 1962, 1982, 2002.
10. According to Investopedia, "The Say's law of markets is an economic rule that says that production is the source of demand. According to Say's Law, when an individual produces a product or service, he or she gets paid for that work, and is then able to use that pay to demand other goods and services."

of economic stimulus. Central bank economists make the crucial error of confusing GDP spending frenzy with sustainable economic activity. They are measuring capital consumption, not production."[11]

In other words, Central banks may be able to create money but they cannot create goods and services. Imagine a nation of energetic hole-diggers. Such an economy could not create prosperity and abundance. It would ultimately create deprivation and penury

Financial Crisis

After each economic slowdown, subsequent to the Crash of 1987, the Fed has reliably lowered the fed funds rate while injecting liquidity into our economic system. In turn, it required increasingly larger injections to stave off each subsequent downturn. Fast forward to 2008. The U.S. was teetering on the financial brink, and the Fed panicked. The remedy was to lower interest rates to zero and initiate massive liquidity injections; and the former program of Fed manipulations morphed into the program dubbed "Quantitative Easing" (QE). By all appearances, the Fed had, once again, "saved" us from financial mayhem. There remains, however, an elephant in the middle of the room that the Fed seems to unwilling, or unable, to acknowledge or address. Here is the issue…

Any Complex Adaptive System (CAS) can remain in a critical state – while appearing stable and innocuous – for an exceedingly long time. One of the distinctive features of any CAS are "inflection points," whereby large changes occur as a result of even minor stimuli. We can observe this phenomenon in the physical world by visualizing the accumulation of snow on a mountain top. Slowly, in an orderly manner, the mountain will grow larger and higher as the snow accumulates. There will likely be a number of small snow slides that are of little consequence. With increasing mass, however, the system potentially becomes progressively unstable. At some stage the system may reach an inflection point where even a very small disturbance could result in an avalanche.

In understanding a CAS it is essential to recognize that one cannot predict if, or when, an abrupt change may occur by observing the individual component parts (e.g., the snowflakes). In other words, the system assumes properties (e.g., stability) that may be related to the component elements (the accumulating snow), but these related elements must be appraised discretely from its component parts. Bottom line: all Complex Adaptive Systems are more complex than the sum of the component parts would suggest.

Consider the inflection point that incited the Fed to panic in 2008. Allowing Lehman Brothers no option but to file bankruptcy appears to have been the catalyst that lead former Chairman Ben Bernanke, together with former Treasury Secretary Henry Paulson, license to respond with the extreme measures of QE, ostensibly to avert a 1930s style Depression.[12] For those who trust the omniscience of our government officials, and the economists most influential in setting policy, here is my question: "If these learned officials were so profoundly unaware that the financial system was then teetering on the brink of a 1930s style Depression, is it even logical to assume that they will be aware when, or if, there will be a next time?" I will leave the reader to draw their own conclusions.

Solutions proffered by government, or government officials, are based on a glaring fallacy: people who are observably deficient in making sound judgements for themselves will somehow rise above their deficiencies once the government sanctions these individuals to choose for others. (Never trust anyone who pays no price for their poor decisions: politicians, bureaucrats, and judges.)

Footnotes

11. For more information on Patrick Barron, see http://patrickbarron.blogspot.com/2014/05/why-central-bank-stimulus-cannot.html.
12. See the movie *Too Big to Fail,* which is based on Andrew Ross Sorkin's best-selling nonfiction book about the players and events that led up to the 2008 financial crisis. While I do not agree with many of the conclusions drawn, the movie did an excellent job in portraying how little control our political elite truly have in dealing with a crisis of any magnitude.

Bracing for the Inevitable

I will now point out the obvious: a market can only be as stable, and rational, as the underlying constituents that, in aggregate, comprise the market. This fact of life was documented as early as in 1841 when Charles Mackay observed, "Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, one by one."[13] I will additionally point out that while knowledge is cumulative, wisdom is not. The ever-present tendency for human beings to panic and behave irrationally should be abundantly obvious to even the most casual observer. There are no new eras; just the same old errors masquerading in new garb.

In the 1 December 2014 edition of *The Credit Strategist*, Editor Michael Lewitt asserted "There will be another financial crisis, almost certainly within the next ten years and quite possibly before the end of the decade. When the crisis comes, the world will not end; the system is resilient and will move to its next stage as it did after the 2008/9 crisis. Some things will be better and some will be worse. The arc of progress will move ahead, but it will not move ahead for everyone. It will move ahead for those who understand what is happening and prepared themselves accordingly." [Sullivan & Serwitz emphasis]

I would add to Mr. Lewitt's remark that if one is prepared, a market downdraft – no matter the severity – should be welcomed by the rational investor, not feared. Furthermore, the more severe the decline, the greater the likelihood we will be able to acquire increasingly compelling investment opportunities – even if that means selling some securities at a loss, in order to raise cash which will be redeployed into evermore compelling opportunities.

Having made this remark, I want to make it abundantly clear that neither Bob nor I wish pain and suffering on others. We believe the misguided policies that have lead us to our current state of affairs is nothing less than a travesty of economic policy, largely perpetrated by the ignorant and self-serving. I additionally believe that we must all take responsibility for today's abysmal economic state of affairs. We have each had a hand in shaping events: some through ignorance, but in many cases through complacency and consent. Finger pointing is not only counterproductive, it will likely exacerbate the impending predicaments.

I will conclude this month's edition of *Commentary* with the following comments by outstanding money manager Seth Klarman, founder of the Baupost Group: "Someday, financial markets will again decline. Someday, rising stock and bond markets will no longer be government policy. Someday, QE will end and money won't be free. Someday, corporate failure will be permitted. Someday, the economy will turn down again, and someday, somewhere, somehow, investors will lose money and once again come to favor capital preservation over speculation. Someday, interest rates will be higher, bond prices lower, and the prospective return from owning fixed-income instruments will again be roughly commensurate with the risk. When will this happen? Maybe not today or tomorrow, but someday."

The U.S., and most of the developed world, cannot pursue their various stimulus programs indefinitely. Only a fool would suggest otherwise.

I will continue my remarks next month.

Working hard for you,

Marshall Serwitz

P.S. Thank you for your support.

Footnotes

13. Mackay, Charles. *Extraordinary Popular Delusions and the Madness of Crowds* (1841).

Thank You

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