Into the Fourth Turning

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Eureka

My first Eureka moment came when I was a seven-year-old boy. I was living in Switzerland at the time, and I had a Swiss version of an erector set – it was extremely versatile. My Eureka moment came when I figured I could power the rear axle of the little car I had built with a rubber band, and if I rigged that rubber band to the front axle in just the right manner, the front wheels would wind that rubber band right back up again and this thing would keep going for miles…

An hour later I was outside in the parking lot of our apartment building with my invention in hand. I wound up the rubber band. Breathless with anticipation, I set the car on the ground.

Nothing happened. It didn't move an inch. I had just joined the futile quest for a perpetual motion machine.

Today, when I read through Keynesian economic analysis that dominates the world's economic policies, I get this queasy feeling that I'm looking at a blueprint of that little car. Here is some of that pretzel logic that feels a lot like someone is describing a perpetual motion machine:

- "Stimulus (deficit) spending will more than pay for itself in the future with the higher tax revenues that come from future economic growth caused by that spending."

- "Government debt is really debt we owe to ourselves. So it doesn't matter."

Huh?

I like to poke fun at "Keynesian" economic thought, but I have great respect for the intellect of the man himself. Unfortunately for us, Keynes' views and policy recommendations were informed by the need for political and practical expediency. This must be right. Otherwise, there is simply no way to understand this comment he made about "The Road to Serfdom" by Friedrich Hayek.

> "In my opinion it is a grand book.... Morally and philosophically I find myself in agreement with virtually the whole of it: and not only in agreement with it, but in deeply moved agreement."

How could Keynes say this about a book that was so deeply critical of his viewpoint? Hayek took a crack at answering that very question in an interview in 1977:

> "His basic ideas were still those of individual freedom. He did not think systematically enough to see the conflicts. He was, in a sense, corrupted by political necessity. His famous phrase about, "in the long run we're all dead," is a very good illustration of being constrained by what is now politically possible. He stopped thinking about what, in the long run, is desirable."

Well, here we are in the year 2010, and "the long run" has arrived. The logical conclusion of Keynes' ideas is exactly what we have today: fiat currencies, piles of sovereign debt, heavily active government fiscal policies, entitlement programs as far as the eye can see and bailout impulses. The sad thing is that Keynes would almost surely be dismayed by this outcome. In 1945, Hayek had a phone conversation with Keynes and asked him if he wasn't getting alarmed about what some of his pupils were doing with his ideas. (They were slipping down the slope and arguing that if a government could lift an economy out of recession by spending, then a government could go ahead and control the entire economic cycle.) He said, "Oh, they're just fools. These ideas were frightfully important in the 1930s, but if these ideas ever become dangerous, you can trust me – I'm going to turn public opinion around like this." Unfortunately, he died three weeks later and never got the chance.

Into the Fourth Turning

We titled this report Into the Fourth Turning in recognition of the fascinating work of William Strauss and Neil Howe on the cycles of Western history. When they published their book by the same name in 1997, they predicted that a financial crisis would shake the foundation of Western civilization near the middle of the next decade. They were right. They also said this crisis would define the nature of the next 10-15 years of US history, and that the crisis would be an opening salvo in a series of crises that would eventually uproot and redefine many of our institutions. The basis for this view? It has happened before with surprising regularity.

Their work is based on an eighty-year cycle driven by the waxing and waning of the values and influence of each generation. "The Fourth Turning" refers to the final 20-year period, a time of upheaval and change when the cultural and economic institutions that

supported the current cycle begin to look wobbly and ill-suited for the challenges that lie ahead. The last three Fourth Turnings ended in 1783 (Revolution), 1865 (the Civil War) 1944 (the Second World War). Early in the Fourth Turning there is usually a crisis that sets the tone. In our case, Neil and Howe looked around and figured that our financial system was approaching the limits of its ability to support the institutions born in the Great Depression and was the likely candidate for the epicenter of the crisis. It looks like they were right.

Niel and Howe point out that it is nearly impossible to predict how fourth turnings will resolve. They are fraught with risk. But it should be clear by now that if this historical pattern of "Fourth Turnings" repeats, the central issue to watch is our pile of debt, the financial systems that created it, and the political institutions that support the whole deal.

Whatever the outcome, this is bound to be a grand showdown between rival schools of economic thought. For seventy years Western nations have embraced Keynes and Friedman policies that imply you can kick the can down the road by borrowing and spending or printing money when the economy is struggling, without consequence. They have ignored Hayek and the Austrian view that this road does not end well. I think that by the end of this fourth turning, round about the year 2020, we will be able to put this debate to rest.

The Greek Cockroach

Warren Buffet once said that there is never just one cockroach. What he really means by this, of course, is that once you see one you can stop looking because you know there will be more. The fiscal picture in Greece is not pretty. Years of plugging fiscal holes with debt have left the nation short on revenues, long on unsustainable promises, and out of options. Even the recent proposed bailout package has done little to change Greece's borrowing costs (which was one of its principle aims), and it does little more than kick the can down the road one more time.

Did I mention that Greece has defaulted on its sovereign debt in 105 of the past 200 years?

It won't be long and one third of the Euro Zone will face similar problems. The PIIGS are the prime candidates (PIIGS = Portugal, Ireland, Italy, Greece and Spain). To put this in perspective, Greece is one thirtieth of the Euro Zone. Governments throughout history have preferred to inflate and devalue their currency (if they can) rather than face the pain of austerity and deflation. We are at the forefront of just such a period, but countries in the Euro Zone face the straightjacket of a currency union. This is bound to be a recipe for civil unrest – "demonstrations" in Athens are probably just the tip of the iceberg. Remember, Europe has spent three quarters of the last 1500 years squabbling, if not warring, over limited resources. Peace the likes of which we have seen over the last 50 years is not the norm. And sure enough, old resentments are right there, just beneath the surface:

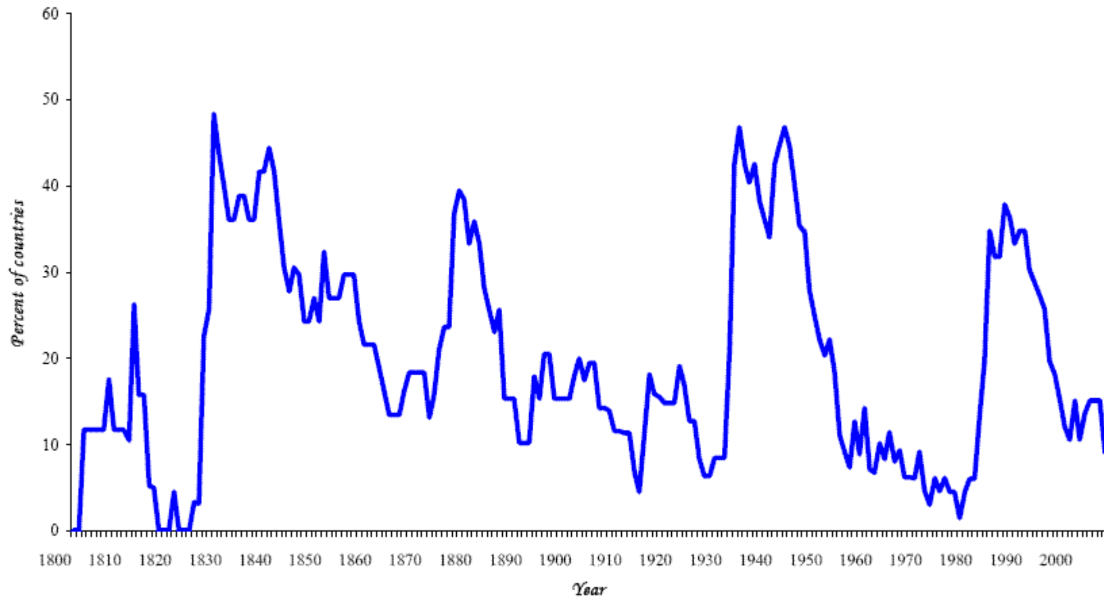
Many Greek citizens believe they deserve a bailout from the Germans, at the very least, since they really still owe war repatriations. (This is a very tame paraphrase of what I've seen in the blogosphere.) This is what the Germans had to say in response:

Not to be outdone, INKA, Greece's umbrella Federation of Greek Consumers, said this: "The distortion of a Greek historical statue of beauty and civilization, at a time when [the Germans] were eating bananas in the trees, is unacceptable and inexcusable from later civilized peoples."

Indeed. This would all be rather funny except that people are getting angry. This is a feature of fourth turnings. It is ultimately social unrest and discontent that drives the challenges to the old institutions and forges the new ones.

Finally, politicians in a social democracy have one overriding interest: get reelected. Given the choice of spending to please the electorate or balancing their budget to please the bondholders, which do you think they will choose? Up next: A wave of sovereign government defaults and/or devaluations, generously called "Restructuring" by in Figure 1 (taken from the work of Rogoff & Reinhart on the aftermath of financial crises.)

Figure 1

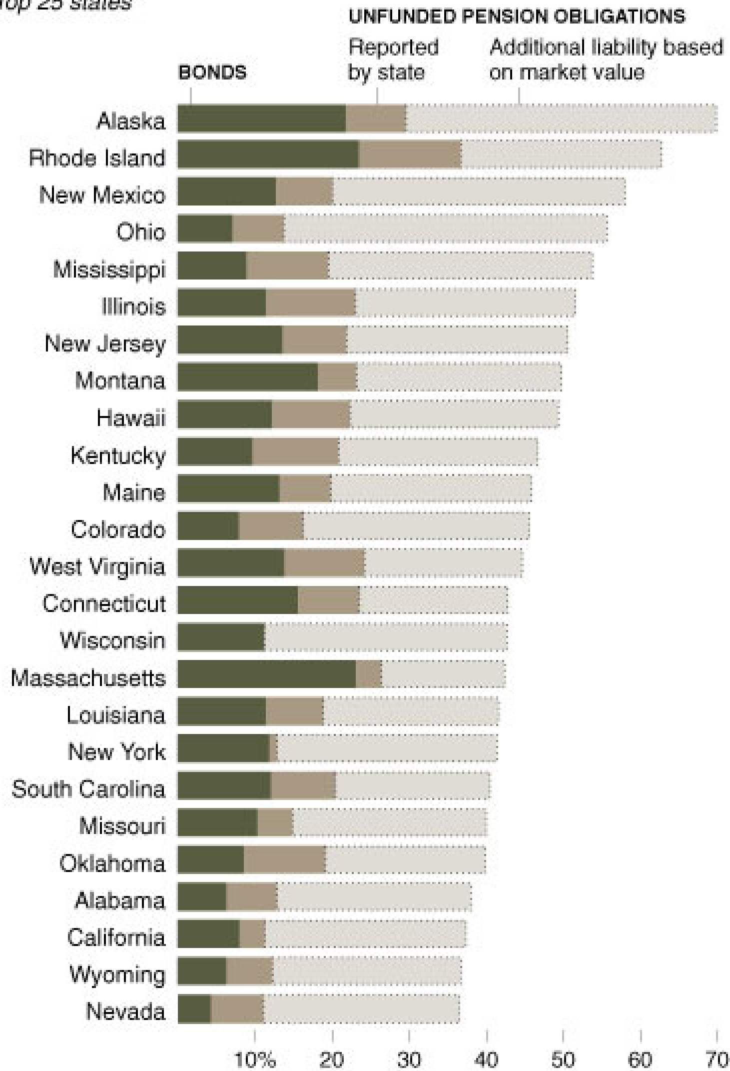


Source: "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises," by Reinhart and Rogoff

Barack Obama's home state of Illinois is looking a lot like Greece these days. "The state is in utter crisis," says Representative Suzie Bassi. "We are next to bankruptcy. We have a $13 billion hole in a $28 billion budget." Libraries are closed one day per week, buses are not running full schedules, schools are owed hundreds of millions of dollars and we are about to lay off teachers. In one county police cars have been repossessed and the prison is refusing to accept new inmates until it gets paid. The state has been "paying" its bills with unfunded IOUs since last October.

Florida, Arizona, Michigan, New Jersey, Pennsylvania, New York and California all face yawning budget gaps as well. The Kansas City Star is reporting Missouri's budget missed its 2009 revenue estimates by a $1 billion. Indiana and Kansas are also finding themselves short on revenues. Worst of all, public pensions are under-funded to the tune of $3.2 trillion, according to Joshua Ruah, an economist at Northwestern University. Figure 2 below paints the grim picture. Add to the debt woes of European nations and US states the unfunded liabilities of the US government ($30 to $50 trillion, depending on who you ask), the bearded nationalization of the largest financial institutions in the world, Fannie and Freddy, and you have to ask, how could this have gotten so bad?

Figure 2



Unholy Alliance Between Banks and Government

Goldman Sachs helped Greece hide 1 billion Euro of its debt through some kind of currency Swap that I haven't tried to understand. This is a cockroach in its own right.

> In the aftermath of the crisis, we learned that Wall Street firms had been helping _______ deceive investors by lending money through convoluted structures that were intended to let ________ claim they were not really loans, and that ______ was therefore less indebted than it was.

Was this written about Greece? About Fannie and Freddy perhaps? About a big bank and its SIVs? An insurance company? Turns out it was written about Enron. But the list of names you can and will be able put in this sentence when all is said and done is apt to be rather large. Martin Wolf, of the Financial Times, has the appropriately angry reaction:

> What is "completely scandalous" is that the Goldman-Greece currency swap was legit under the rules of the day, Wolf says. "It's another indication of ways in which governments connived with the financial sector all over the world to do things they really shouldn't have allowed to happen."

And what Wolf finds "absolutely terrifying" is there appears to be no appetite in Washington D.C. to substantially reform derivatives regulation, meaning these kinds of Enron-style accounting practices remain standard operating procedure for governments, corporations and the banks that finance them.

While I can sympathize with Mr. Wolf's sentiments, this is really not that surprising. This unholy alliance dates back to 1694 and the founding of the Bank of England. The King of England desperately needed to rebuild his navy after a series of crushing defeats at the hands of the French. The treasury was empty and there was no appetite to buy the bonds of a sovereign power that kept getting beat up by the French. So the King created a buyer for his bonds – the Bank of England. It was established as a private institution and the English Crown gave it monopoly powers to issues currency in exchange for the purchase of government bonds. The King managed to raise all the money he needed in just 12 days.

Today, this alliance extends well beyond monopoly rights to issue currency. With each financial crisis, governments effectively grant banks more power. The Federal Reserve, FDIC insurance, lower and lower reserve requirements, fiat currencies – all these institutions and rules benefit the banks, forgive them their sins of the past and let them continue with business as usual. Today is no different. The Federal Reserve is now pushing to eliminate reserve requirements altogether. Mark to market accounting has been suspended indefinitely, allowing banks to keep assets on their books at whatever value they want. Some of the proposed regulation in DC institutionalizes the bailout function – allowing the Treasury to cut checks as needed in future financial crises to avoid the delay of a Congressional vote. And the bearded nationalization of Fannie Mae

and Freddy Mac may be the biggest of all. On Christmas Eve, 2009, the Treasury announced that it would remove any limit to the funds it would supply these two behemoth financial institutions. Make no mistake: these institutions turn around and fund the activities of banks around the country by buying mortgages from them. They now have a blank check, courtesy of you and me, to do this as needed. All of this is done in an effort to bring the banking sector back from insolvency, as the government has done time and time again for the last 130 years. Will they succeed this time?

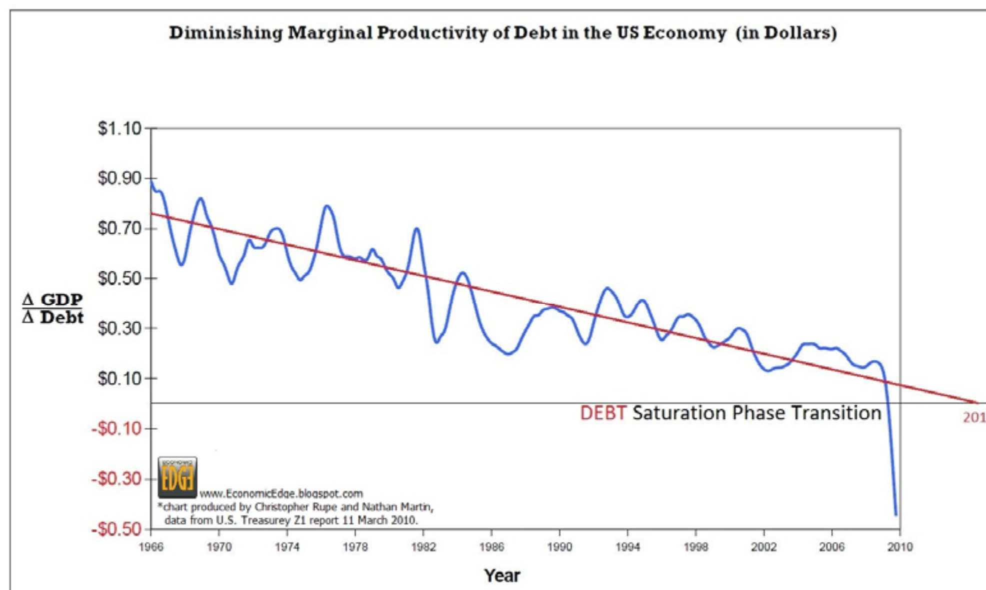
Rocking Horse Winner

Bill Gross writes a great monthly letter to his bond investors. His latest missive gets at the heart of this very question. He phrases it this way:

> "Can [governments] successfully substitute the government's fist for Adam Smith's invisible hand and for how long? Can [they] escape the debt crisis by creating even more debt and riding another rocking horse winner?"

The metaphor of the rocking horse winner (which he adapted from a short story by D.H. Lawrence by the same name) is really very good. It implies increasingly frantic attempts to achieve the same result. And that is precisely where we are in our debt-laden world. Figure 3 below is a potent illustration of this fact. For much of the country's history, every new dollar of debt also expanded the economy by $1. Then, in the late sixties something changed. After separating from the gold standard and unleashing the full power of fiat currencies and fractional reserve banking, each new dollar of debt generated less and less economic activity. We appear to be approaching a point of no return, where more debt may be needed just to keep the economy afloat, let alone grow it. Hmmm. Where have I heard this story before? Ah yes, Japan.

Figure 3



Bill Gross answers his own question in the following manner:

> "The answer, from a [bond] vigilante's viewpoint is "yes," but a conditional "yes." There are many conditions and they vary from country to country, but basically it comes down to these:
>
> 1) Can a country issue its own currency and is it acceptable in global commerce?
> 2) Are a country's initial conditions (outstanding debt, structural deficit, growth rate, demographic balance) moderate and can it issue future public debt as a substitute for private credit?
> 3) Can a country's central bank be allowed to reflate via low or negative real interest rates without creating a currency crisis?

This analysis is basically correct. Conditions in the US pass all three tests, and it looks like we will get another ride on the rocking horse. But it begs the question: what happens next time? The trend in Figure 4 below simply cannot go on forever, and yet it is clear that our system is deeply dependant on expanding debt levels. I couldn't find the updated version of this, but just as a reminder:

Figure 4

Can we push this ratio to 400%? 500%? Maybe, but then what? The bottom line is that the US economy has to get moving in that direction, and fast, or unemployment will continue to rise, the economy will stall and asset values will start to fall again. This is our conundrum. We know we are hooked on a stimulant that could kill us, but we just can't function without it, and our governments are administering it at a record pace.

Fingers of Instability

John Maudlin, a market seer with somewhat agnostic economic views, recently recapped an analogy he has used to describe the nature of our unstable financial system. Imagine a pile of sand that is fed by a stream of sand from above. Eventually the sides of the pile get steep enough that they approach a "critical state" and are prone to "avalanching." Physicists have learned that predicting where and how this will happen is virtually impossible, but they can recognize when conditions become unstable. Then, all it takes is one grain of sand in the right place and a chain reaction follows. The point of all this, of course, is that our sand pile of debt is getting enormous, it seems to be prone to more and more frequent slides, and we need to add sand faster and faster to keep the economy growing at the same pace.

So here we are. Spring of 2010. What can we say about the sand pile? In my very unscientific opinion, it is today more stable than it was in the fall of 2007, for 3 reasons.

1) We just lived through a major slide – this has reset the stability of the pile somewhat.
2) Governments the world over have implied that everything, including small nations like Greece, is too big to fail and will be bailed out.
3) Governments are delivering enormous fiscal stimulus.

This is why markets of all sorts have rallied so far, so fast. The problem now is that in order to deliver on all of the above, governments are pouring their own sand (debt) onto that pile even faster than ever. (Think rocking horse winner.) But it also means that conditions of instability could reappear even faster as well. And this time, the crisis will center on government debt and the bond markets. The collectivist impulse spawned by Keynes as a solution to fiscal problems brought on by the bad behavior of banks and the governments who cover for them will have gone as far as it can. There will be no one left to bail out "the system." The US government will be left with a nasty choice: austerity and fiscal discipline, or monetizing the debt and face a likely collapse in the bond market. Neither scenario is any good for the economy or for equities. But don't take my word for it – here is Federal Reserve Bank of Kansas City President Thomas Hoenig, from a speech in March:

> The fiscal projections for the United States are so stunning that, one way or another, reform will occur. Fiscal policy is on an unsustainable course. The U.S. government must make adjustments in its spending and tax programs. It is that simple. If pre-emptive corrective action is not taken regarding the fiscal outlook, then the United States risks precipitating its own next crisis. ...

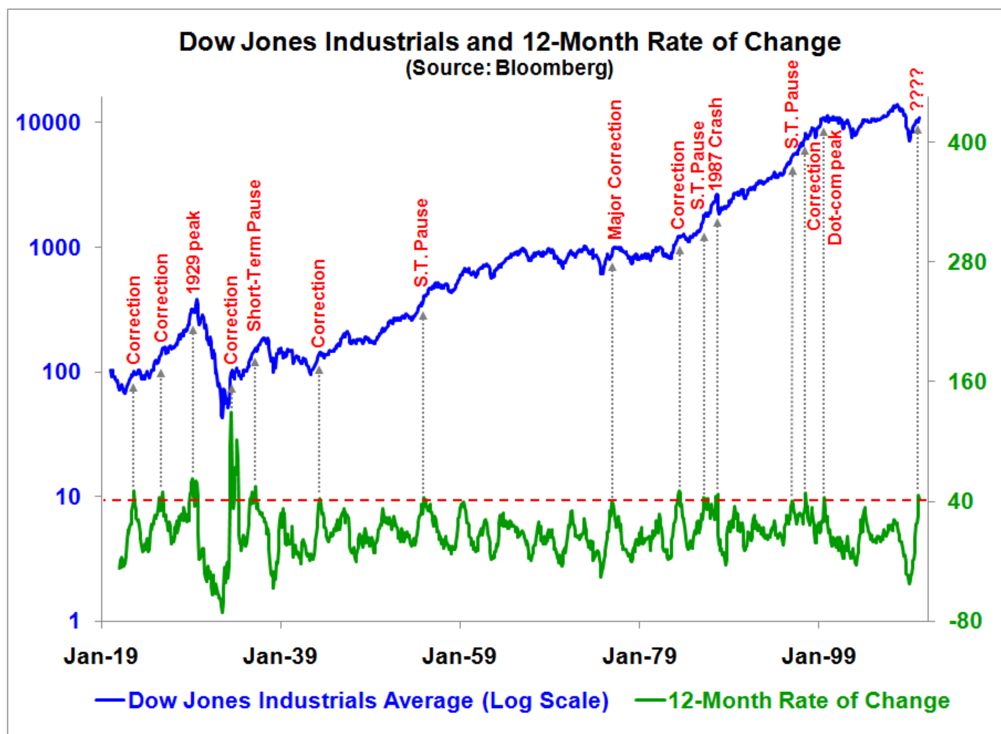
Even Federal Reserve Chairman Ben Bernanke, with uncharacteristic bluntness, warned Congress in February that the United States could soon face a debt crisis like the one in Greece, and declared that the central bank will not help legislators by printing money to pay for the ballooning federal debt.

Investment Positioning

So, as investors, what are we to do? As usual, timing is the critical question and, just like the physicist watching the sand pile, all we can do is estimate that it may yet be a couple of years before the conditions for another crisis are in place.

The equity market is currently dramatically overbought and technically ripe for a correction – this means prices may move sideways or down for a bit, but they are unlikely to resume their steep ascent immediately. There is a lot of history supporting this view: over the last 100 years, when the twelve-month rate of change in the Dow exceeded 40%, the market tended to pull back by 5%-10%. In three of fifteen instances it instead moved sideways for a few months before resuming its uptrend. (See Figure 5.)

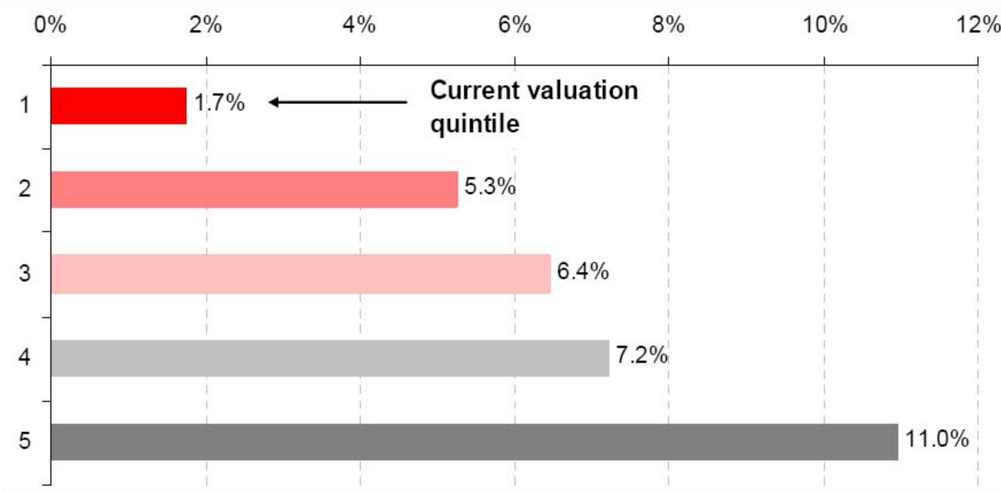
Figure 5



In the fall last year we had advocated putting on a small short position (1/4 of the long position we suggested in February of 2009) round about the 1005 in the S&P500. Over the next month we would cover that short as the market comes in. Although we are not out of the woods by any means, the implied bailout

guarantee by governments around the world could support asset prices for a long time in the face of bad news. Having said this, we simply cannot advocate a buy and hold posture here. Figure 6 below shows that valuations have again gone to speculative levels that were supported by the boom in credit of the past 25 years. This fits with the government "blank check" that is underpinning asset values, for now. But Figure 5 also shows that long-term equity returns from here are typically anemic. Given that we are approaching the end of a "debt-super cycle," as Maudlin likes to call it, I would take the under on that bet.

Figure 5



The big question is how long will this last? One month? Six months? Three years? Do you want to take the chance that you will recognize when to sell? Historically a reliable timing indicator has been the inversion of the yield curve. This usually meant that the

Fed was tapping on the breaks and it was time to step aside. It is possible that history will repeat in the same manner. It is also possible that the American economy is so laden with debt that even taking the foot off the gas will be enough to slow things down this time. Oh, did I mention that the Fed just finished its quantitative easing programs on March 31? The monetary gas pedal is easing up off the floor even now. John Hussman of Hussman Funds says it well.

> It's one thing to say, "From every historical precedent, we know that this is going to end badly, and investors will lose a great deal of their wealth, but for now, they are speculating anyway." It's another thing to add, "and since they are, we are actually going to rely on investors to continue behaving dangerously, and *join* them."

I, for one, am not willing to join them, because rule one in the world of investing is capital preservation, I learned a long time ago that there is no such thing as a perpetual motion machine, and I think even Keynes would be troubled by the financial landscape of the world today.

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