Parking the Car Backwards

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Double Dip? Can you really fall down again if you're still on your knees?
Hamilton, Krugman and the Gallows
Fossil Fuels and the Genetic Drift of Ideas: Keynes vs. Hayek

"2008 was not the big one."
- Jerry Jordan, President of the Federal Reserve Bank of Cleveland, 1992 - 2003

Parking the Car Backwards

Two years ago, my parents dropped by my house for an all-day barbeque. That afternoon I decided we needed some fruit from the store. I jumped into my Honda Pilot and got in my first fender bender – by backing out of my garage and into my parents' car. What an awful feeling.

Well it gets worse. Last week I did exactly the same thing – to my wife's car. You can barely see the damage on her car, but my poor Honda Pilot has now had two fender benders in the same spot and it's starting to look a little ragged, what with the taped up tail light. Another one of those fender benders and it may need serious time in the shop.

Our economy is looking a lot like my tail light these days, and it just can't take much more pounding. Our financial and political systems (they are inextricably linked), unfortunately, are prone to making the same mistakes over and over again, just like I do when I'm driving in reverse. This opinion is shared by others far more qualified than I am to pontificate on such matters:

Jamie Dimon, CEO of JP Morgan, in testimony before Washington lawmakers probing the cause of the financial crisis, said the following:

> "My daughter came home from school one day and said, 'daddy, what's a financial crisis?' And without trying to be funny, I said, 'it's the type of thing that happens every five, ten, seven, years.' And she said: 'why is everybody so surprised?' So we shouldn't be surprised…"

Even more ominous is the comment I quote at the beginning of this report: *"2008 was not the big one."* Jerry Jordan, President of the Federal Reserve Bank of Cleveland from

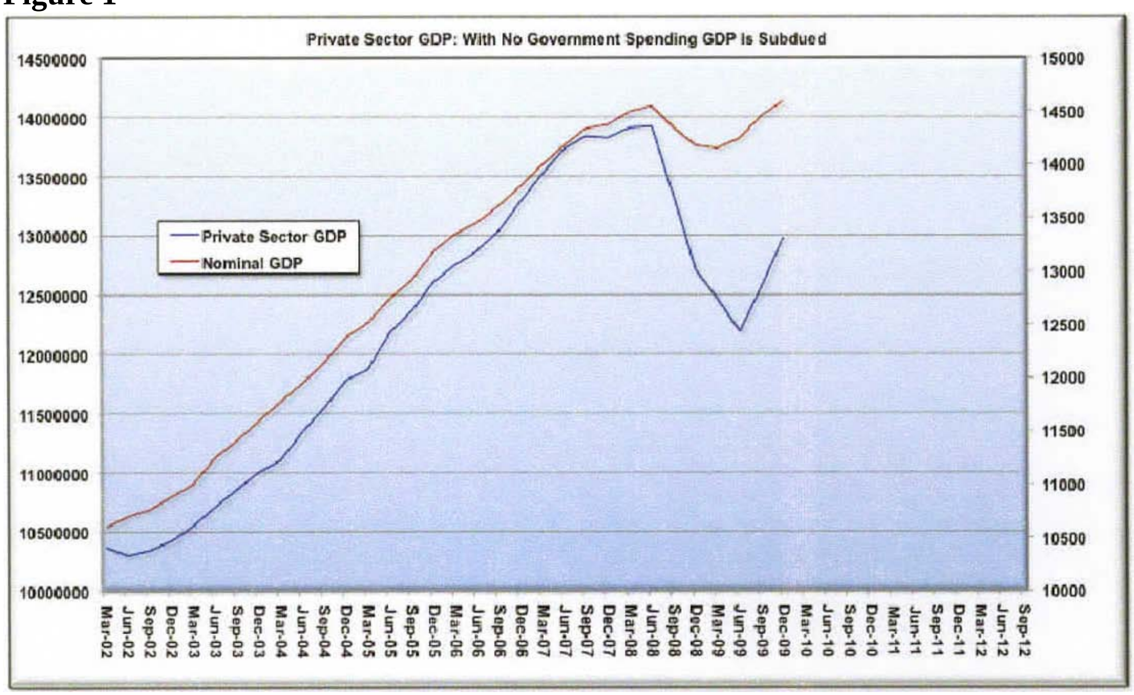
1992 – 2003 said this at a conference two months ago and was referring to the financial crisis of 2008. He thinks there will be another crisis, only bigger. In the course of his speech he made it clear that the attempt to fix the system in the aftermath of 2008 was akin to the packing tape holding my tail light together. It was far from the serious changes needed to avoid the mistakes of the past. We need to learn to park the car backwards in the garage. That is the only way to make sure that we won't back out and hit my mother-in-law's car. That would indeed be the big one.

Double Dip? Can you really fall down again if you're still on your knees?

Some call it a double dip. Fed Chairman Bernanke calls it a period of "unusual uncertainty". David Rosenberg, former chief economist at Merrill Lynch, calls it an on-going depression. Call it what you will, we are in for a rough patch over the next few quarters, and any growth over the next few years is likely to disappoint. Below are the best charts I've seen that support this view.

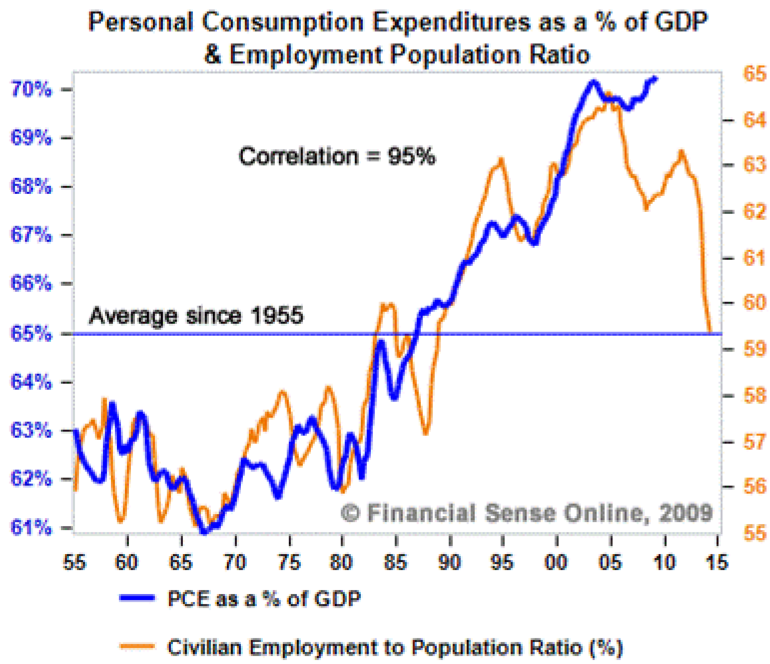
Government "stimulus" is ending (for now) which will reveal the underlying weakness of the private sector. This first chart speaks for itself. The contraction in private sector GDP was about 10% from peak to trough - a depression event by any standard, and much of the bounce has been inventory restocking. Fading government stimulus will now push total GDP (red line on top) down toward private sector GDP (blue line).

Figure 1



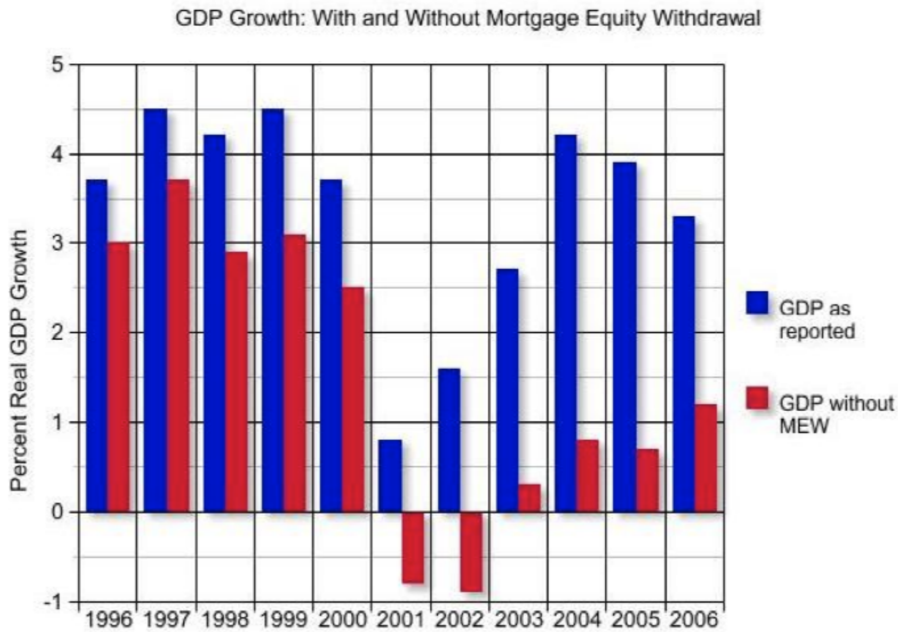
Private sector spending will stay weak because of the horrible job situation. Figure 2 shows civilian employment as a percent of the US population *leading* consumer spending (PCE) as a percent of GDP much lower. The lead-time is about 4-5 years. This is common sense. You have always needed a job to get money to buy stuff. After you've held that job for a while, you can get a loan to buy more stuff. Everything starts and ends with employment. Between now and 2015, consumer spending as a percent of the economic pie will shrink.

Figure 2



Private sector spending will stay weak because the debt-fueled consumption that got us out of past recessions is missing this time. Figure 3 depicts what GDP growth would have looked like after the dot-com bubble burst without the huge benefit of mortgage equity withdrawals (MEW) on consumer spending. There is nothing to replace it today. Is it any surprise that economic growth today is behaving more like the red bars than the blue bars?

Figure 3

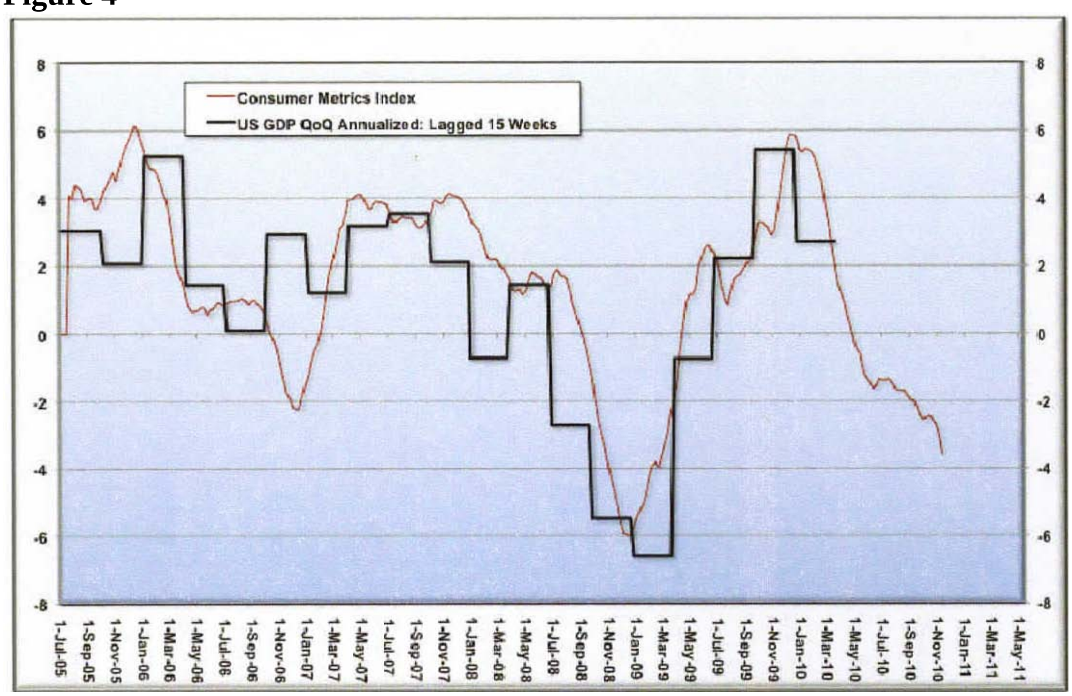


Source: frontlinethoughts.com

A particularly weak patch lies directly ahead, as measured by two of the best indicators around: The Consumer Metrics Index and the ECRI.

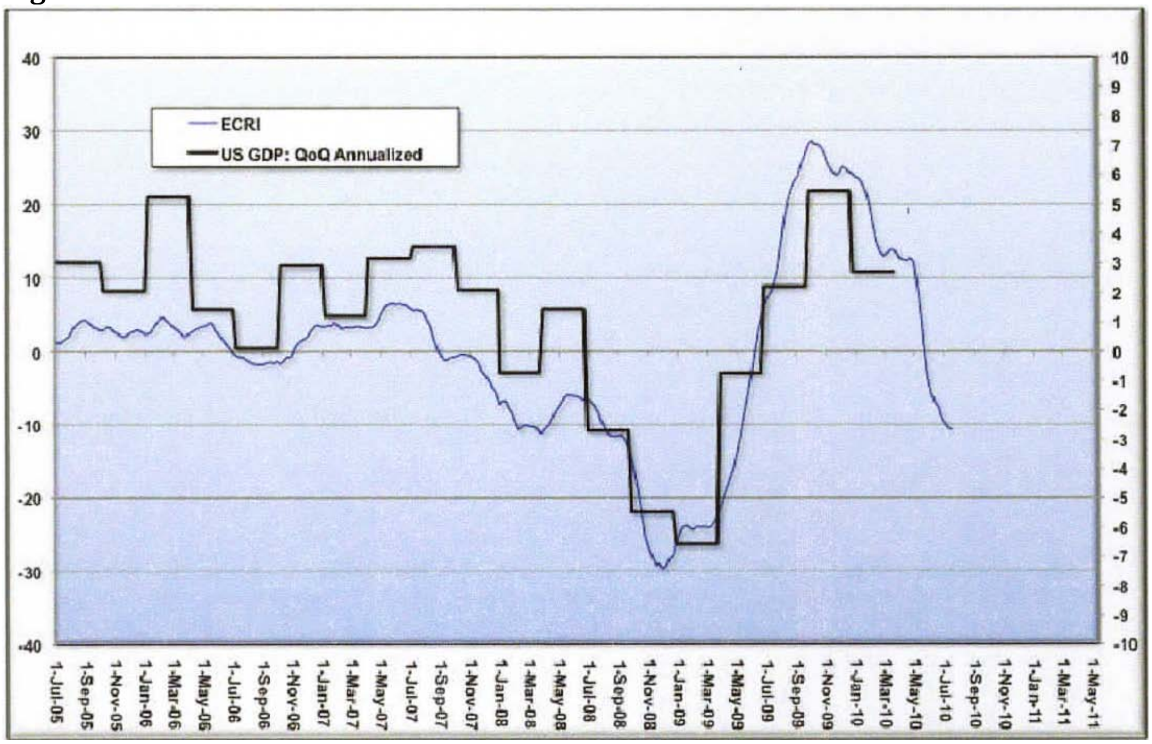
The Consumer Metrics Index measures point of sales data on consumer discretionary goods and services. It forecasts GDP rather well and suggests at least one quarter of negative GDP growth by next year. Given the employment and credit situation, we can infer that this is likely to be a recurring pattern in the years ahead.

Figure 4



The ECRI was the darling of the bulls just one year ago. This summer the bulls have been stumbling about trying to explain why its recent plunge does not necessarily mean the V-shaped recovery belongs on the trash heap of bad forecasts. They have become quieter recently, as the ECRI is at levels that previously have always led to a contraction in GDP.

Figure 5



Finally, David Rosenberg points out that at this point in past recession recoveries GDP is growing by 6% on average -- not the appalingly slow 1.6% reported in the second quarter of 2010. This, in spite of the largest peace-time fiscal stimulus and the most aggressive monetary policy in the history of the world. It gives one pause, does it not?

So now what? In our view, the best case is that the economy will be weak through early next year and will probably post one quarter of negative growth along the way. The worst case is that a shock of some sort (another war in the Middle East, another terror attack, or a sovereign default in Europe) puts us into another more serious downturn.

Hamilton, Krugman and the Gallows

Is there nothing policy-makers can do?

Asked the same question, Dr. Jerry Jordan answered (I am paraphrasing here): “I am your doctor and you’ve just asked me to prescribe a cure for a hangover. The answer is that it can’t be done.” Like the morning after, we are in the process of realizing just how drunk we were on cheap money, credit and debt, wishing we hadn't over-indulged, and trying to clean up our act.

Unfortunately, we have a gaggle of politicians and economists in Washington force-feeding us the same drug that got us sick. If the economy falls back into recession, we can expect even more of the same from government; more debt-funded stimulus (perhaps a smaller version if Republicans win majorities in both Houses), and more quantitative easing by the Federal Reserve (known in less polite circles as money printing). It didn't seem to work very well the first time – will it work better next time? Are these policies really a good idea? Our Founding Fathers didn't think so.

Zero Hedge, that wonderfully irreverent blog, posted a challenge to Paul Krugman and all like-minded economists and politicians who push these policies:

> "I present an open challenge to Paul Krugman and all like-minded economists, Nobel prize winning or not, that support the monetary policy of dollar debasement. This will be a straightforward challenge issued by our Founding Fathers, in particular the first US Treasury Secretary, Alexander Hamilton, who scripted the US Coinage Act of 1792. The one question I want to see Mr. Krugman and his supporters answer is this:
>
> **"If monetary debasement can truly create economic recovery, why did our Founding Fathers establish, in the US Coinage Act of 1792, that any persons discovered to be deliberately debasing US money 'shall be guilty of felony and shall be punished by death'?"**
>
> Note that the punishment was not imprisonment, not even hard labor, but death. Why did our Founding Fathers, who had just gained freedom from the draconian monetary policies of the British monarch King George through the American Revolution and the Treaty of Paris in 1783 deem that monetary stability could not be separated from the conditions of freedom? Why did they deem the act of monetary debasement so insidious that anyone found guilty of deliberately debasing US money would not be imprisoned but should be punished by death? And why is monetary debasement today accepted as the "right thing to do" and "normalized" by prominent economists like Paul Krugman?"

Our Founding Fathers did this because they knew their history – and history argues that debasement of the currency can create short booms but eventually cripples an economy, not to mention that it benefits some groups over others (bankers and politicians over the common citizen, in broad strokes, because they get the newly-printed money first and get to spend it before prices go up).

So why has our system worked for as long as it has? Were the founding fathers wrong? Will another round of currency debasement and "fiscal stimulus" work this time? Is Krugman right that we just didn't do it big enough the first time? The answer to these questions, I believe, can be found at the bottom of an oil well.

Fossil Fuels and the Genetic Drift of Ideas: Keynes vs. Hayek

"Survival of the fittest" is the phrase widely recognized as the upshot of Darwin's theories – it turns out that's where the story ends. Evolution actually starts with gene mutation – also known loosely as "genetic drift". If the mutation gives an owl better night vision, the mutation will get passed along since this owl is more likely to hunt better than its cousins and to find a mate. After a few hundred generations of owls, the mutation will be in all owls.

When a mutation creates a deaf owl, natural selection, or "survival of the fittest," makes sure that gene doesn't get passed along. But here's the twist.

What if this poor deaf owl had the good fortune of being born right when the population of rabbits took off. I mean really, took off. He could drop out of the sky just about anywhere and he would catch a rabbit. No need to hear the subtle rustling in the briar patch. Now, natural selection would take a back seat – every owl, including our deaf owl, is fat, happy and successful, so his genes get passed along because he can bring home the catch as well as the next guy. A dozen generations later and 10% of the owl population is deaf – but it doesn't really matter – until the bunny population suddenly goes back to normal.

Ideas are like genes. Ideas mutate, and the "fittest" ideas survive natural selection. Good ones (like property rights) are passed along and bad ones (like slavery) end up on the trash heap of history. If the economic ideas that dominate DC today are as bad as our Founding Fathers thought, why are they still around? Why have they not been selected against? Because of the explosion of the bunny population.

For the past 150 years, we have been riding a huge wave of increasing prosperity, thanks to the transformative power of fossil fuels (this assertion is probably worth its own letter – but if you think about the key difference between our civilization and say, the Greeks, it's energy). The improvement in standards of living has been incredible. As measured by the cost of food, material wealth has increased tenfold – in 1900 75% of the average American's income was spent on food. Today that number is about 8%. At no time in history have living standards improved at such a rapid pace.

This era of increasing prosperity has been the equivalent of bunnies running around all over the forest floor where any old deaf owl could catch one. Against this backdrop, bad economic ideas were never really put to the test – the US economy thrived in spite of policies inspired by these bad ideas.

Today, something is changing. Keynesian policies are beginning to prove less effective, at best. (In all fairness to Keynes, the ideas that we call "Keynesian" are half-baked versions of the real thing.) It is not clear how the next five to ten years will unfold, but it seems to me that "natural selection" is in play again, and Keynesian ideas will be challenged in the years to come by schools of thought that do not rely on central planning and constant tinkering with income redistribution, taxes, asset prices and interest rates.

Friedrich Hayek and the Austrian School of Economics have a thing or two to say about all of this. Interestingly, Americans seem to be listening: since 2008 sales of Hayek's "The Road to Serfdom" have quadrupled, and the book is ranked #1 in Amazon's Political Theory category, #1 in its Economic Theory category, and #141 overall.

Investment Positioning

Our long-term view remains unchanged. We are 10 years into a secular deflationary bear market that will probably carry through the middle of this decade, and we continue to believe that the ultimate low for equities still lies ahead. The single most important goal for an investor in this environment is to preserve purchasing power until that time. We are still holding cash, cash equivalents, short term federal debt, high-quality corporate bonds and pre-refunded municipal debt.

As to the near-term for equity markets, the old Keynesian habits of our policy-makers -- debt-fueled government spending and central-bank money printing – tend to put a bid under stocks. At the margin, these policies are not working as well as they used to, but they will not stop working over-night. Said another way, there is an unusually intense tug of war between the deflationary forces of too much bad debt and the inflationary policies of the Fed and the government. Which will assert itself in the equity markets at any given moment is very hard to tell. Barring a shock that pushes the economy from its feeble state into a sharper economic contraction, it is not clear that equities will decline much from these levels over the near-term (in spite of their overbought condition as we go to press), and may even rally into year-end in concert with historical seasonal patterns.

The bigger problem is that our policy makers are still pulling out of the garage in reverse. They are bound to repeat the mistakes of the past until they park the car backwards. Let's just hope they figure that out before they total the car completely.

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