August 3, 2012

"Where is the wisdom we have lost in knowledge and where is the knowledge we have lost in information."
-T. S. ELIOT

Let there be hope. Hope is one of the simplest yet most comforting words in the English language, at least when it comes to the real deal. This is in vivid contrast to the false variety, the kind that emanates from Washington DC with nauseating regularity. "Mission accomplished," "subprime is contained," "help is on the way," "yes we can," yadda, yadda, yadda.

As serendipity would have it, one of America's great thinkers, Woody Brock, visited our Bellevue main office in mid-July. Given that he comes to the area as often as good things happen to Seattle sports teams, the odds against his trip were about as long as seeing our former all-star centerfielder start his first game *against* the Mariners. (So long, Ichiro—at least your batting average is assured to soar by 51 points or more now that you are playing with the boys in pinstripes!)

The fact that I've been planning for months to devote a full EVA to his theories, to be written this week (well before I knew he would visit us in person), makes it even more uncanny. Then, to top off the remarkable string of coincidences, *Barron's* ran a feature article on one of his key concepts—health care reform—mere days after he visited Evergreen's main office.

Some of you may recall the EVA from back in May when I did a very brief recap of Woody's new book, *American Gridlock*. At the time, I promised to do a more comprehensive overview and that moment is at hand.

In case you were among the 99.999% of the planet's population that didn't read that issue, I tried to make the case that Woody's solution set to our most intractable problems was the best I've come across. Possibly a bit more compelling than my endorsement is the fact that *American Gridlock* received rave reviews from numerous luminaries. These include Nouriel Roubini (who achieved international fame by predicting the global financial crisis), Felix Rohatyn (the man who "saved" New York City in the 1970s), and Mort Zuckerman (editor in chief of *US News* and *World Report*). *American Gridlock* has also earned fervent endorsements from a long list of other economic and investment heavyweights.

In my opinion, one of the reasons Woody's book has received such remarkable accolades is that it is brimming with plausible remedies and, hence, hope. While he is unflinching in his attacks on the stupidity of many of our current policies—and policymakers—he is one of the few qualified experts who clearly states what needs to be done to avoid a self-inflicted economic catastrophe. What appeals to me the most is that his solutions aren't left or right—they are simply rational, a state of mind the blustering boobs on Capitol Hill seem incapable of attaining.

Moreover, newsletter titan John Mauldin earlier this year devoted two consecutive weekly issues of his *Outside the Box* service, received by more than 1 million folks around the world, to summarizing *American Gridlock*. Taking my cue from him, I've decided to break my overview of Woody's book into two parts. There is just so much great information and so many innovative solutions that trying to fit it all into one issue didn't seem feasible.

One of my main goals with this EVA is to entice many of you to read Woody's book. In fact, I feel strongly enough about this to offer the first 25 readers who contact us a complimentary copy

of *American Gridlock*. But check out my first installment on it before you decide.

Back to basics—and the classics. Unless one is incredibly dense—say, a career politician—it's impossible to look at the state of our country, as well as the world, without realizing something is terribly amiss. While there are many probable causes, perhaps one of the most critical and overlooked is the way we think as a society. In Woody's words, "unsound thinking abounds everywhere today."

Having read *American Gridlock* twice, as well as many of Woody's other writings, the most unusual aspect about him in my view is his classical education background. By that I mean that he was reading Greek philosophers while still in grade school. Consequently, at a very tender age he was familiar with the deductive logic techniques of Plato and Socrates.

Don't worry—I'm not going to go esoteric on you because, unlike Woody, I was pretty much zoned out during whatever courses I had on Plato and his gang of like-minded deep thinkers. But it's really not that hard to grasp the concept even for a philosophically challenged person like me.

Deductive logic is basically the idea that a theorem or conclusion should proceed from an axiom or first principle and then be able to be mathematically verified. A simple example he uses is from another classical mind, Euclid, the father of geometry. One of Euclid's famous axioms is that on a plane there is one and only one straight line that can connect two dots. And, when added to other similar axioms, he also proved, beyond doubt, that the sum of the angles in every triangle must equal 180 degrees. Again, this is an irrefutable fact—an assumption, irrevocably proven—also known as a theorem.*

Woody notes that for 2,000 years, such precise premise-to-conclusion thinking was primarily associated with mathematics. Then, due to the work of folks like Princeton's Johnny von Neumann and his somewhat more celebrated colleague, Albert Einstein, the same process was applied to physics. In 1932, von Neumann demonstrated how the formulas for quantum mechanics could be deduced mathematically from five axioms or first principles.

He also illustrates how a deductive logic approach can filter out extraneous and confusing data—a pernicious problem in this era of constantly escalating information overload. He points out that two of the most famous formulas in the world—Newton's Force = Mass times Acceleration and Einstein's Energy = Mass times the square of the Speed of Light (F=MA and E=MC2)—have just three variables.

As the 20th century progressed, such deductive logic processes moved beyond math and physics. Brainiacs like another Princeton scholar, John Nash, made famous to the general public by the film *A Beautiful Mind*, showed that these methods also applied to economics and social sciences. Nash's breakthroughs on game theory were essential in preventing the Cold War from becoming very hot—as in thermonuclear.

Starting in the 1960s, however, our country and its leaders seemed to lose the plot.

Duped by data. The alter-ego of deductive logic is inductive logic, essentially number crunching. As Woody makes clear, a fanatical faith in data and data analysis has taken ascendance over the former Socratic process. (Vietnam-era Defense Secretary Robert McNamara had a legendary faith that numbers could solve almost anything, an attitude that was sadly disproven by the outcome of that long and grueling war.)

Thus, there has been an inversion in our collective thinking in that we first analyze the numbers,

then we create axioms and finally come to conclusions (of dubious quality).

Woody believes that the glissade down this icy slope started during the "culture wars" of the 1960s when so much of what had been considered essential and incontrovertible was rejected as "bourgeois" and outdated. The deductive reasoning or dialectic methods of Plato and Socrates fell into almost total obscurity during the 1960s (save for Mr. Spock on *Star Trek*!) In its place rose the altar of induction or data analysis.

One deleterious consequence of the deification of data was the false premise that financial markets were perfectly efficient. Because of this belief, it eventually came to be assumed that leverage could be used in massive quantities when the data indicated that a certain outcome was "assured." The folly of this inductive logic assumption almost crashed the global financial system in 1998 due to the efforts of hedge fund Long-Term Capital and its phalanx of Nobel Prize-winning savants.

The most recent and devastating example of this was the inductive conclusion that home mortgages always default in predictable ways. After all, that's what the data unambiguously said. Much of the investment world came to believe this, a classic case of what Woody calls "correlated mistakes." In other words, the financial wizards of the world were almost all making the same bet and the same mistake: that mortgage defaults would maintain their past pattern. Naturally, to juice returns (and bonuses), they employed immense sums of leverage.

Few thought to wonder what the wages of all the Wall Street alchemy of junk-quality mortgages into allegedly AAA packages (CDOs, in Street speak) would do to the data. The fundamental logic that housing prices far above their long term average would almost certainly loss experience was also ignored. As we all know now, the implosion of the home lending bubble set off the horrific chain reaction that took the world to the brink of financial annihilation.

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Woody also correctly points out that the blame should not be totally laid at the Street's feet. Congress was also deeply complicit in spreading the contagion of toxic debt that inflated the housing bubble. (As a side note, one of his other key assertions is that runaway leverage has caused excessive economic volatility without any growth benefits. Consequently, he proposes

strict limits on overall debt accumulation using guidelines similar to the Taylor Rule on interest rates that the Fed successfully followed for years.)

While inductive logic clearly failed us all miserably over the last five years, if not longer, it is still being applied to two of the most important and interrelated areas of our financial future: our national debt and our rapidly unfolding healthcare debacle.

The exhilarating news is that there is rational hope for disarming both of those time bombs. But it does require looking at each of them through the lens of a much more rational viewfinder—a device based on demonstrable logic that can then be proven by incontrovertible mathematics.

When the orthodox collides with the paradox. In case you think there is nothing as absolute in economics as either Force=Mass times Acceleration or Einstein's mythic E=MC2, consider this: GDP = C + I + G + E. Trust me, like most of you, I have a genetic aversion to formulas, but this one is very intuitive once explained:

Gross domestic product equals consumption (C) plus private investment (I) plus government spending (G) plus net exports (E).

The reality is that this formula is just as much of an absolute as either Newton's or Einstein's and it's incredibly important given what's happening in the world today.

As Woody observes, and all but the most incoherent (or hopelessly biased) beings realize, what looms ahead, barring radical reforms, is the complete collapse of the welfare states in the so-called "rich" countries. Europe is, of course, ground zero in this great reckoning. As bond markets have revolted, driving up borrowing costs to bankrupting levels for the "sinner" countries, there have been frantic efforts to reduce government spending in the GDP equation above.

Unfortunately, as warned in past EVAs, these deficit reduction efforts are proving to be self-defeating (with even the UK recently backing away from its exceedingly ambitious austerity program). The negative impact on the economies of the weaker countries from deep budget cuts is sinking them further into recession, thereby making deficits worse not better. (Don't worry, I'm not about to go Keynesian on you here!)

The problem is that the formula above is truly an absolute. There are no exceptions. If the government is "dis-saving" (i.e., running a deficit), it adds to overall GDP. Again, this is an inarguable fact, not an opinion (though one could challenge the quality or sustainability of that growth driver). If the government is "saving," or running a surplus, it is a drag on growth (though it can be a good thing during booms, which our country has rarely done since 1970, other than in the late 1990s during the headiest days of the tech bubble.)

Let's look at the present US situation. Our deficit is currently running around 7% of GDP. Therefore, by definition, reducing it to a more sustainable level of 2% would require a government spending drop of 5%. This in turn necessitates that the other components of GDP must rise by the same amount; otherwise, the economy contracts by the difference. Thus, if government spending comes down by 5%, but the others "only" increase by 3% (a fairly heroic assumption), the economy will shrink by 2%. (By the way, at our current level of nanoscopic growth, that would be enough to push us back into recession. This is one reason investors should be on high alert about the "fiscal cliff" next year that might take a 5% chomp out of GDP.)

Given all the uncertainty floating around, it's unlikely that either consumption or investments will surge enough to offset a 5% fiscal drag. In fact, they might feed on each other as has happened in Europe. Lower government spending leads to layoffs, which reduce consumer confidence and spending. This, in turn, inhibits investment expenditures by both individuals and businesses—a classic vicious circle. Again, this isn't conjecture—it is playing out in real time right now in much of Europe.

Yet staying on the present course of running massive deficits is not feasible either. The bond market vigilantes are back with a vengeance and those who think they won't eventually come charging after the US are beyond naïve.

Thus, most of the developed world—Japan is also a fiscal basket case—is about ready to be gored on the horns of a most dangerous dilemma. Orthodox budget-balancing measures are colliding with the paradox of thrift—when both governments and the private sector seek to reduce spending at the same time things get very messy. Fortunately, there is a way out—at least if we do some logical thinking.

Next week we'll examine Woody's convincing and very hopeful case for how we can tame the twin monsters of the federal budget and healthcare spending—before they devour us. If you're tired of the same old, same old from those on the left and right, you should find this most refreshing. Better yet, get your hands on a copy of Woody's book!

David_Hay_Signature

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*In mathematics, a theorem is a statement that has been proven on the basis of previously established statements, such as other theorems, and previously accepted statements, such as axioms. The derivation of a theorem is often interpreted as a proof of the truth of the resulting expression, but different deductive systems can yield other interpretations, depending on the meanings of the derivation rules. The proof of a mathematical theorem is a logical argument demonstrating that the conclusions are a necessary consequence of the hypotheses, in the sense that if the hypotheses are true then the conclusions must also be true, without any further assumptions. The concept of a theorem is therefore fundamentally deductive, in contrast to the notion of a scientific theory, which is empirical.

(Source: Wikipedia)

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