

February 22, 2013

"The idea that policy makers can perfectly unwind (their) unprecedented easing without some unintended consequences is theoretically possible but...unlikely."

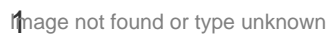
-MICHAEL HASENSTAB, MANAGER OF THE FRANKLIN TEMPLETON GLOBAL BOND FUND, RANKED NUMBER ONE AMONG ITS PEERS OVER THE LAST DECADE.

The cover story curse. The notion that the front covers of leading magazines are reliable contrary indicators is well known among veteran market commentators. An example of this theory, which has attained mythic status since it first ran in 1979, was the *Business Week* cover story, proclaiming the "Death of Equities." Not long after, stocks launched into one of the greatest bull markets of all time.

Over the years, I've poked particular fun at *The Economist* for its role in this publishing version of "Wrong Way Corriganism." In late 2008, with stock markets reeling around the world, it ran a cover depicting a lion pierced by several arrows with the headline: "Capitalism at Bay." At the time, I opined that this was likely to be THE embarrassing cover story of the future. Indeed, both stocks and economic growth mounted a spirited comeback over the next year.

Yet, periodicals like *The Economist* and *Business Week* also get it right—occasionally. For example, *The Economist* showed some prescience by predicting trouble in the US economy in its April 2008 cover story. At the time, the stock market was close to its highs and most of the forecasting community was blind to the approaching tempest.

Accordingly, I'm re-visiting my familiar position, way out on a precarious limb, to say that I believe *The Economist* nailed a major theme when it ran this cover earlier this month.

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Of course, the snarling Viking above will never be confused with Kate Upton, of *Sports Illustrated Swimsuit Edition*, fame. But I believe the 14-page Special Report, that is the showcase of this issue of *The Economist*, is one of the most important articles the storied British "newspaper" (as it refers to itself) has ever run.

Minsky Moment, Part II? To back up that bold assertion, I would like to return to one of the main themes from last week's EVA wherein I raised my ultimate worry: What happens to the financial markets once the Fed turns off its magical money machine?

Call me simplistic (it wouldn't be the first time!) but I believe the Fed will be staring down a fairly basic decision tree once money begins coursing through the economy's veins at anything approaching a normal rate:

- 1) Do nothing (in other words, just what it did when the housing bubble was inflating).
- 2) Start *rapidly* selling its multi-trillion dollar bond portfolio. (Can you hear the yelps of protest from Paul Krugman already?)
- 3) Start *gradually* selling its multi-trillion dollar bond portfolio (which could take a century or so).

Now, let's contemplate the implications of each of these. As relayed in last week's EVA, courtesy of Philadelphia Fed Chairman, Charles Plosser, the first option will lead to consumer prices tripling. That's not a great outcome unless you happen to be loaded to the gunnels with gold, silver, or both (based on the abysmal current price action of those metals, not many seem to be hedging against such a scenario). Bonds will, by definition, be slaughtered.

The second approach might be imperative from an inflation containment standpoint, but to anyone with a sliver of awareness of how the markets operate it should be obvious that this means utter chaos for bonds. With money velocity accelerating by this time, the bond market would already be on its heels, causing the Fed to feverishly dump enormous supply into an already staggering marketplace. Maybe I'm missing something, but I don't see how that won't morph a bad situation into a bloodbath.

The third approach might sound like the ticket but, frankly, I don't think the net result between options 2 and 3 is much different. Having witnessed Fed tightening cycles before, and particularly the last episode in 2004, as soon as the markets get a whiff that the Fed is switching gears, the reaction is sudden and brutal. Based on the massive overhang of bonds that the market knows has to be dumped, I am convinced the carnage this time will make the spring of 2004 look as substantial as any of Kate Upton's swimsuits.

So, the Fed will be damned if it does (even a little) and if it doesn't. The bond market is the most obvious victim of this but, based on how severe the turmoil is likely to be in fixed-income land, it's almost inconceivable stocks will be immune. It's at this time we will all re-learn the Econ 101 maxim that there is no free lunch. Despite the Fed's best (worst) efforts, the reality is you can't print your way to prosperity.

Magnifying all of this, not that it needs to be, is that wonderful phenomenon that helped make 2008 such a joyous year: the carry trade. This is where financial entities (think: hedge funds) borrow short-term money in copious amounts in order to speculate invest in longer term debt instruments. In this way, the prevailing pedestrian yields can be chimerically converted into luscious double-digit returns. These, of course, are what generate the lucrative 2 and 20 (2% and 20%) profit splits that are the brass rings of the hedge fund world.

This works beautifully until the leveraged assets of choice begin to fall in value. If this sounds familiar, it's because that's exactly what happened with sub-prime mortgages, and other debt instruments, back in 2006 and 2007. While the good news is that real estate lending is no longer at the center of the latest carry-trade frenzy, which made the unwinding of that episode so painful for the banking system, the bad news is that it could be worse in other ways.

Interest rates have now been held at Lilliputian levels for so many years that the use of this type of return alchemy has become deeply entrenched. Moreover, there is a nearly ubiquitous belief that money will continue to be cheap almost indefinitely, leading to a very dangerous sense of complacency. (For those who have read the work of the late economist Hyman Minsky, this is the classic situation that creates "the Minsky Moment.")

Once one of the three above scenarios begins to play out, the Fed will be in its most difficult quandary ever. It won't be able to cut interest rates because they are already at zero and it won't be able to print more money to buy additional government bonds because it will be trying to do the exact opposite. If you're starting to feel sorry for Ben Bernanke, don't. It's my contention he'll be long gone by then, leaving someone like Janet Yellen to solve the insoluble.

To be fair, the Fed believes it has another choice and that is to use a new tool it's been granted from Congress: the ability to pay interest on bank reserves being held at the Fed. Thus, it believes it will be able to keep all the trillions of excess reserves (the modern-day equivalent of printing money) effectively out of circulation. It feels that by raising the rate it pays high enough, banks will keep their funds with the Fed rather than lending them out to the real economy. It

could work—but I'm not counting on it. And per the opening quotation, it's interesting that Michael Hasenstab, one of the savviest bond managers around, isn't either.

My skepticism is based on (besides the Fed's own repeated blunders over the last 15 years) two considerations: One, it will still be sending a strident sell signal to hair-trigger and overleveraged bond ~~speculators~~ investors; two, it will remain stuck with trillions of dollars of bonds that have to be sold at some point. A bond market in full bear mode is likely to be very unforgiving of that gargantuan supply overhang.

Of course, if markets really get slammed through this process, the velocity of money will once again implode, giving the Fed some breathing room to restart its magic money machine. Yet, this will only make the eventual exit strategy that much more daunting.

If you've been wondering what this all has to do with a Viking and a super-model, it's now time to explain.

A good crisis. It's my belief that most Americans still think of Sweden as the bastion of cradle-to-grave socialism. And for many years, that's exactly what it was. However, in the early 1990s, Sweden's economic system experienced what the rest of the rich world did in 2008: a spectacular real estate bubble that led to a crash and the implosion of its banking system. It took a different tack than the US did when its banks were effectively bust. Instead of bailing them out and protecting bond investors, Sweden nationalized, and then recapitalized, its financial system with public funds.

However, the US has shown that a TARP-type approach makes sense when almost all collateral values have plunged to unrealistically low levels (rendering almost every bank insolvent). This is what happens when you have a systemic margin call as we did back in 2008. (Many Evergreen clients remember the unsettling experience of seeing high-grade bonds fall 40% in a few weeks due to the mass liquidation.)

But the big difference is what happened next. Sweden, unlike the US today, instituted a series of reforms that reinvented its iconic welfare state from top to bottom. What had been a crippling government debt load, equal to 70% of GDP in 1993, was cut to 37% in 2010 (note that the US debt-to-GDP ratio is now over 70%, even excluding the Treasury debt owned by the social security trust fund).

Similarly, Sweden transformed its federal deficit from 11% of GDP in 1993 to a 0.3% surplus by 2010 (despite the aftershocks from the global financial crisis). Public spending, which as a percentage of the overall economy had almost doubled from 1960 to 1993 to a near Soviet-like 67%, has been gradually dialed back to 50%.

Therein lies an important lesson: While 50% is still a high number compared to the US, Sweden is trending the right way (also, when adjusted for the way we pay for our healthcare, the gap isn't that large). Conversely, the US is increasing the size and reach of government, with dramatically higher taxes and a regulatory pandemic.

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To achieve its renaissance, Sweden needed to reject some of the core principles of socialism. It replaced its social security-like defined benefit national pension scheme with a defined contribution version. It also established a universal system of school vouchers. Private education companies were invited to compete with public schools. For-profit enterprises were permitted to vie with each other, and government entities, to provide healthcare services.

The net result of these efforts, and many others, was that Sweden, which had fallen from the world's 4th richest country in 1970 to 14th by 1993, now ranks 3rd in terms of overall prosperity. It also claimed the top spot in a composite rating that evaluated global competitiveness, innovation, ease of doing business, and human development. Moreover, Sweden's gross government debt level is far below those of the US and Europe. In fact, all the Nordic countries have sovereign balance sheets about which Americans, and most Europeans, can only feel achingly nostalgic.

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The following sentence from *The Economist's* lengthy article neatly sums up the remarkable attitude shift that has occurred: "The leftward lurch has been reversed: rather than extending the state into the market, the Nordics are extending the market into the state." Again, the contrast with what the US is presently doing could hardly be more vivid.

It is certainly true that all of the Nordic nations are relatively small in terms of population and none has an economy as large as California's. Yet, again quoting from *The Economist*, there are ample reasons to scrutinize, and possibly emulate, their success: "The first is that they have

reached the future first. They are grappling with problems that other countries too will have to deal with in due course, such as what to do when you reach the limits of big government and how to organize society when almost all the women work. And the Nordics are coming up with highly innovative solutions that reject the tired orthodoxies of left and right."

That last sentence particularly appeals to me as it echoes one of the key themes from my *12 Step Program for America* EVA from two years ago (for part one of the essay, [click here](#); part two, [click here](#); part three, [click here](#)). The US political process remains intellectually ossified. Neither party can figure out that its traditional nostrums are no longer working in the post-global financial crisis world. The Democrats seem incapable of comprehending that the private sector does a much better job of running almost everything than does the government (especially when the former isn't crippled by an onerous and Byzantine regulatory structure).

The Republicans don't seem to grasp the fact that in a wealthy, modern, and aging country, a significant amount of socialism is unavoidable. The political coalition that realizes capitalism and socialism need to symbiotically co-exist will be the one that bends our present downward trajectory back up toward true fiscal sustainability and economic prosperity.

Although most of *The Next Supermodel* article centers on Sweden, it also examines the various challenges countries like Finland (with its overreliance on fallen tech giant Nokia), Norway (with its overexposure to oil), and Denmark (which lacked either world-class companies or energy resources) all had to face in reinventing their economies and social contracts. And, in each case, it took an existential crisis to catalyze the drastic overhauls.

As the article repeatedly points out, the Nordics are inarguably still grappling with vexing problems, mostly a legacy of their past "sounds good/works bad" hard-left economic policies. As Danish historian Viby Mogensen has observed: "The welfare state we have is excellent in most ways. We only have this little problem. We can't afford it."

Eventually, that same inescapable reality will permeate the psyche of the American left (though I have my doubts Paul Krugman will ever come around). As I've noted in numerous past EVAs, it's often the *nominally* liberal party that institutes essential reforms. This was also the case with our new favorite destination for bond investments, Canada. Its metamorphosis from the Banana Republic of the North to one of the world's few remaining AAA sovereign credits has become legendary. In my view, it's no coincidence that the Nordics are also in that select AAA-rated—and steadily shrinking—group. They all essentially followed a remarkably similar recovery plan, heavily focused on entitlement reform.

But back here in the good ole US of A, there seems to be almost no sense of what needs to be done. What's it going to take to change that incredibly reckless attitude?

True north. It has been my contention that one of the worst consequences of the Fed's "binge-printing" (kudos to Evergreen's Jeff Otis for that pitch-perfect description) is that it undercuts any urgency by the politicians to make the hard but essential decisions. It's so easy to keep imitating an ostrich when you can finance record-breaking debt at less than it cost years ago when we owed much less. Thus, the Fed is the enabler of our government's deficit addictions as it hoovers up nearly all longer term Treasury issuance.

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Combined with the stock market's steady rise, heavily propelled by the Fed's limitless liquidity injections, there is a growing perception that things must not be as bad as most of us sense in our guts. This leaves folks like me in the unenviable position of pointing out that this bull market's foundation is imported straight from the Sahara Desert.

One of the smartest political pundits around is Greg Valliere. As relayed in an EVA last fall, Greg is convinced our inspired "leaders" are going to stay in their present blissful state of denial (with a few commendable exceptions) until the next cataclysm. Unfortunately, I believe he's right.

The Fed's inevitable multi-trillion dollar portfolio liquidation gets my vote for when this delusional state will be thunderously shattered. Then, I believe, being the long-term optimist I am, a few brave souls in our nation's capital will step forward and implement the type of reforms that the role model countries of Scandinavia put in place 20 years ago.

Once that happens, the resulting surge of confidence, along with the powerfully positive trends of US energy abundance and the accelerating return of manufacturing to this country, will catalyze the next bull market breakout. It will be the real deal, not a Fed-manufactured phony.

In case this all seems too much to hope for, consider the alternative. Well, there really isn't one other than going through the paroxysms that southern Europe has endured (with more to come, I'm afraid). And at the end of the day, even if we do go down that sorry road, the rationalizations of the welfare state still need to occur.

To throw in another ray of sunshine to end this otherwise sobering EVA, I'd like to relay a set of prescriptions to restore America's solvency and stature from David Rosenberg. As many EVA readers know, David is chief strategist and economist at Toronto-based investment firm Gluskin Sheff, and his 10-point recovery plan is right up there with the best I've come across (see on the next page). In addition to being one of the most glittering stars in the forecasting firmament, he is a native Canadian. As you've already read, it's abundantly clear they know a thing or two about how to turn a country around. It's time to swallow our American pride and follow the northern lights, whether they radiate from Canada, Scandinavia, or even, based on its

extraordinary recovery, the wee country of Iceland.

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