May 16, 2014

"The whole aim of practical politics is to keep the populace alarmed (and hence clamorous to be led to safety), by menacing it with an endless series of hobgoblins, all of them imaginary."

-H.L. Mencken

If it's May, it must be Mauldin. As avid EVA readers are aware, this is the time of year for the annual Mauldin/Altegris Strategic Investment Conference (SIC). Consequently, several Evergreen team members and I are in San Diego (I know, tough duty). It's an exciting time as the always-stimulating SIC has helped us develop some crucial long-term insights over the years. Consistent with our custom, we will be recapping the most compelling ideas and themes that we attain at the conference in upcoming EVAs.

This year's slate of speakers is once again impressive, with giants of the investment world such as Jeff Gundlach, David Rosenberg, Kyle Bass, and, our partner Anatole Kaletsky. Additionally, my close friend Grant Williams will be presenting, his maiden oration at this prestigious confab. My only disappointment is that, unlike last year, our other senior partners, Louis and Charles Gave, will not be speaking as originally planned.

Accordingly, I thought I'd dedicate this edition of our monthly "Guest EVA" to a pair of essays Louis and Charles recently authored. (Some of you undoubtedly read Louis' piece in our recent Daily, but it's worth reviewing!) As you will see, Louis is addressing the theme I've written about in our last two EVAs: The shockingly low level of interest rates in most of the world (which is turning out to be a very hot topic at this year's SIC). Contrary to what almost all pundits expected at the start of the year, these yields have dipped even lower in nearly every developed country.

Louis gives several concise reasons why the era of yields-gone-missing might not end anytime soon. (As an aside, my view is that ultra-low yields may continue to persist for much longer than expected by the investment community at large, at least for creditworthy issuers. However, I continue to believe that there is a 2008-like reckoning coming for weaker borrowers where financing rates are nonsensically low and lending terms are also irrationally easy.)

Charles' essay relates to a book you may have read about, *Capital in the Twenty-First Century*, by French economist Thomas Piketty. It recently hit number one on the Amazon best-seller list and, reportedly, numerous senior US government officials are captivated by its central message of aggressive wealth redistribution.

Now, you may think that "French economist" is synonymous with socialist, if not Marxist. To be sure, many of Piketty's proposals would warm the cockles of old Karl's heart, such as an 80% tax on incomes over $500,000 and an *annual* 10% wealth tax for large fortunes (e.g., for someone with a $10,000,000 net worth, making $1,000,000 per year, they would actually pay out almost twice as much as they earn!). Yet, Charles is also a French economist and, as you will see, he vehemently disagrees with several of Mr. Piketty's core themes.

Some EVA readers may recall that I have long believed a wealth tax is inevitable in the so-called "rich" countries whose governments (ex-Canada) are increasingly impoverished. Moreover, I feel that if properly structured (i.e., low rates and nearly zero loopholes), a US wealth tax, combined with much lower personal and corporate income tax rates (again, with the elimination of almost all deductions), would likely catalyze a growth boom and a restoration of our national

balance sheet.

As indicated by the runaway success of Mr. Piketty's book, there is intense interest in the wealth tax issue among the intelligentsia. Those of a more practical bent, who realize the growth-killing impact of his proposed confiscatory tax rates, especially on income, might want to start offering alternatives. Devoid of a more pragmatic solution, the Pikettys of the world may capture the minds of the planet's politicians and the hearts of their voters.

WHY ARE BOND YIELDS SO LOW?
Louis-Vincent Gave

As long as men continue to age, they will probably complain that "things were better in their day" and that "the world is going to hell in a hand-basket". Ignore for a moment that the proportion of undernourished people fell from 23% of the developing world in 1990-92 to under 15% in 2010-2012, that more than two billion people gained access to improved sources of drinking water in the past decade, and that never in history have so many people across the globe lived so comfortably—as far as financial markets are concerned, the 'old-timers' may have a point.

Indeed, anyone who started their financial career in the late 1990s has had to deal with the Asian Crisis, the Russian default and Long Term Capital Management failure, the Technology, Media, Telecom (TMT) bubble and collapse, the subprime bust and global financial crisis, the eurozone crisis and the past 12 months' bond market taper tantrum and emerging market wobbles. In other words, there have been plenty of opportunities to catch the volatility on the wrong side. And these recurrent punches in the gut (combined with the recent violent rotation from growth stocks to value stocks or the fall in the renminbi), may explain why so many investors continue to seek the shelter of the long-dated treasuries, bunds and Japanese Government Bonds, despite these instruments' apparent lack of value. Simply put, after almost two decades of repeated financial crises, investors today do not have their forebears' tolerance for pain. And so the old timers may be right: today's young people are wimps, for both theoretical and practical reasons:

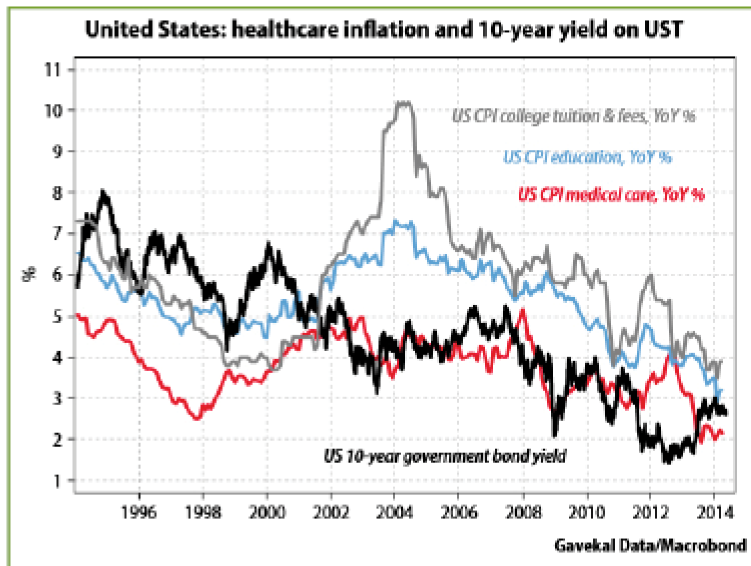
- An inherent level of systemic risk? Most people intuitively feel Karl Popper’s observation that: "In an economic system, if the goal of the authorities is to reduce some particular risks, then the sum of all these suppressed risks will reappear one day through a massive increase in the systemic risk and this will happen because the future is unknowable". In other words, suppress risk somewhere and it comes back with a vengeance to bite you on the derriere at some later date. Look at 2008 as an example: we cut up credit-issuing risk into tiny parcels and distributedit across the system through securitization, only to see the banks take on a lot more leverageand ultimately sink their balance sheets on instruments they failed to understand. Hyman Minsky summed up this inherent contradiction well when he stated that "stability breeds instability". In other words, the more stable a thing is, the temptation rises to pile on leverage, which makes that "something" more unstable on the back end.

- The notion of Anti-Fragile: the above brings us to the Nassim Taleb notion of "anti-fragile": just as a parent who overly cocoons a child prepares that offspring poorly to function in the wider world, so policy-makers intent on cushioning the private sector from every shock in the economic cycle are doing the overall system a massive disservice. By preventing the build-up of immunity, or the ability to thrive in crises (i.e., anti-fragility), policymakers sow the seed for a greater crisis down the road (hence the repeated cycle of crises).

- Lay the blame on zero interest-rate policy (ZIRP): following on the above, not only does ZIRP allow the survival of zombie companies (which drags down the returns for everyone) but it most certainly affects investors’ behavior. Firstly, by encouraging banks to play the yield curve and buy long bonds, rather than go out and lend. Secondly, because almost all investors hold part of their assets in equities and part in cash or fixed incomes. And in a world in which fixed income instruments yield close to nothing, the tolerance for pain in other asset classes probably diminishes all the more. Indeed, if an investor is guaranteed a 7% coupon on his fixed income portfolio, then a mild sell-off in equity markets can be easily dismissed. But drop the yield on the bond portfolio to 2.5% and all of a sudden, the slightest drop in equity markets risks pushing the overall returns of the total portfolio into the red... Unless, of course, one holds much more fixed income instruments than equities. Paradoxically, that growing population cohort which seeks a guaranteed level of annual income faces the perverse reality that low bond yields force an even greater allocation of their savings into bonds! And this quandary is further amplified by the last point.

- The changing structure of savings: a generation ago, employees of large corporations would typically be enrolled in that company’s "defined benefits" pension plan. This meant that most salary-men, at least in the US, could look forward to a fixed monthly sum upon retirement, regardless of a) how long they lived for and b) what the market did. At that time, the overall behavior of financial markets was the concern of the pension fund’s managers who, if they were wise, could average up in bear markets and take some gains off the table when markets got hot; in other words, stomach the volatility of financial markets (back-stopped by their companies’ long-term earning power) for the long-term benefit of their plan holders. But today, following the evolution of most pension plans away from "defined benefits" to "defined contribution", the average pensioner’s relationship to his pension has been turned on its head. Today, the average saver receives a monthly statement explaining how much he has saved; and any dip in that amount triggers sentiments of panic and fears that a looming retirement may not be well provided for. Combine that fear with rises in healthcare and college costs (two costs that older folks have to worry about) that, over the past decade, have typically continued to outstrip inflation and any dip in the market is more likely to trigger a sentiment of panic, and rapid shift

into bonds, than a willingness to ‘buy on the dip’.



Putting it all together, it seems hard to find one factor that explains the low level of yields. In our view, the ageing of our societies, ZIRP and the low level of rates, the shift from defined benefits to defined contributions, the activism of policy-makers (who, by attempting to cushion the volatility of the economic cycle more often than not end up increasing the volatility of financial markets down the road)... have all had a hand in keeping interest rates low. And if that is the case, then it will probably take a marked change in some of the above factors to trigger a significant rise in bond yields?

THE PROBLEM WITH PIKETTY
Charles Gave

Thomas Sowell coined a marvelous phrase to describe the well-intentioned social engineers who always know what needs to be done to improve the wellbeing of the downtrodden. He called them "the anointed" and explained how their reasoning always evolves in the same three stages:

1.) They identify a problem, which may or may not exist. But whether it is real or not, they always insist the problem is caused by market failures.

2.) They propose a solution, which inevitably involves a greater role for the State—and for themselves as its high priests (high priests do not work, except within the Temple).

3.) When their solution fails (as it invariably does), they don’t re-examine their thinking, but just complain that it has been implemented with insufficient vigor. Needless to say, they put forward a new and improved plan they insist will work better next time...

Thomas Piketty is one of France’s great (self-)anointed. Like the rest of his cohort, he eagerly supported François Hollande in the run-up to the 2012 presidential election. Once voted in, the great man started to follow Piketty’s advice, and massively raised taxes on capital. Naturally the policy failed miserably, so Piketty has published a book which explains—predictably—that his recommendations only failed because they were not applied on a worldwide basis. Apparently this book has now become a best seller.

The extraordinary thing is that Piketty’s analysis is based on a massive logical error. His thesis runs as follows: if R is the rate of return on invested capital and if G is the growth rate of the economy, since R>G,

profits will grow faster than GDP, and the rich will get richer and the poor poorer. This is GIGO (garbage in, garbage out) at its most egregious. **Piketty confuses the return on invested capital, or ROIC, with the growth rate of corporate profits, a mistake so basic it is scarcely believable.**

Let me explain with an example. I happen to be a shareholder in an industrial bakery in the south west of France. It has a return on invested capital of 20%, but we cannot reinvest the profits in the company at 20%. If we were to reinvest the profits by putting more capital to work, the profits would not change at all, because nobody in the region is going to buy more bread and

productivity gains there are non-existent. In other words, the marginal return of one more unit of capital put to work is zero. So instead of reinvesting in the bakery, we distribute the profits among the shareholders and they invest them elsewhere as they see fit. In short, our bakery has a high ROIC but no profit growth.

At the other extreme, a company expanding rapidly according to a "stack ’em high, sell ’em cheap" model might well show a low ROIC but very fast profit growth. Every company in the world can be "mapped" according to these two criteria: ROIC, and the growth rate of corporate profits.

Over the long term, the growth rate of corporate profits cannot be higher than the growth rate of GDP. That’s simply because if it was, after a while corporate profits would rise to reach 100% of GDP, which we all know is silly. Historically, the ratio of domestic profit to GDP has been a mean-reverting variable (see On Profits: There Will Be No Revolution and US Corporate Profits: On The Roof Or In The Stratosphere).

In reality, all Piketty has done is to rehash the great Marxist theory about the "unavoidable impoverishment" of the working classes, recasting it as a theory in which the capitalist class gets richer and richer over time, and everyone else poorer and poorer. We only need to look at the history of the last 150 years, or of the last 20—in which two billion people have escaped poverty—to see how valid this theory has proved to be.

Still, it was fine for Marx to confuse the ROIC and the growth rate of corporate profits, because he worked in the days before William Jevons, Eugen Böhm-Bawerk, Knut Wicksell, Joseph Schumpeter and Alfred Marshall, who between them developed the notion of the marginal return on one more unit of capital. Alas, one cannot make the same excuse for Piketty, who is writing more than 100 years after this discovery.

The next question, then, is: why has his book become a best seller? The answer was provided a long time ago by the early 20th Century Italian economist Vilfredo Pareto, who argued that to the governing and chattering classes a theory can be:

1.) true and useful

2.) false and useful

3.) true and useless

4.) false and useless

Here a "useful" theory is one that increases the power of the anointed, not one that benefits the population at large. Theories that fall into the "false and useful" category are grasped especially fiercely by the anointed precisely because they help them to consolidate their political power. Keynesianism is a prime example.

Which brings us to Schumpeter. In *Capitalism, Socialism and Democracy* he made a fabulous remark which throws more light on the matter. He explained that the rise in living standards allowed by capitalism through the process of creative destruction was going to drive a huge rise in the educational level of the population. The educated but uncompetitive would grow to hate the capitalist system, under which their merits were not recognized, and would try to seize control of educational and cultural institutions in order to teach the youth that markets do not work.

Much the same idea was expressed by the Italian Marxist Antonio Gramsci. If these fellows were to take control of the cultural and educational world, then 30 years later the political system would fall into their hands like a ripe fruit. Then they would be able to use the democratic process to destroy the free market, having first brain-washed the electorate.

Don’t get me wrong, I am absolutely in favor of education. But I am against a centralized educational system, easily controlled by the anointed.

This leaves open a question: why do intellectuals hate free markets? Because, as French sociologist Raymond Boudon explained, **in a free market they would be paid at their real value.**

Their success in controlling not ideas, which are uncontrollable, but the teaching of ideas, continued Schumpeter, would inevitably lead to a shift from a democratic, market-based system, to tyranny and poverty.

This is exactly what is happening in the old world today. An over-educated, self-anointed elite is fighting tooth and nail to defy market forces and preserve its position in the educational and cultural system. Piketty, as one of this elite, is being feted accordingly. Nothing new there.

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