Never Say Never Again (Part I)

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"That men do not learn very much from the lessons of history is the most important of all the lessons that history has to teach."
-ALDOUS HUXLEY, Collected Essays

Definitive statements tend to separate "legends" from "losers". "Legends" live in lore as women or men with the clairvoyance and courage to make a bold (and correct) prediction in a time of uncertainty. Think of Winston Churchill's stirring speech: "Men will still say, 'This was their finest hour.' "

"Losers", on the other hand, tend to be forever maligned for making unadvised public declarations in instances where predictions and outcomes don't mesh.

In the case of our ~~fanciful~~ faithful Fed chair, Janet Yellen's recent remarks could be one of those moments that define her legacy. During a Q&A session on June 27th, Yellen boldly stated that she "didn't believe" another financial crisis would happen in our lifetime.

What ever happened to the adage "Never Say Never?" Central bankers, considering their sorry forecasting record, should be particularly wary of those words.

For bulls that bank on such statements, it would be wise to remember that history shows us corrections can be fast and furious. As the following pages outline, October 1929 was one of those times where a definitive statement got a well-regarded economist in trouble within a matter of weeks. And for those whose memories don't date back to 1929, what about October 1987? Leading up to Black Monday, one statistician told Ted Aronson, founder of institutional investment firm AJO, that the 1987 crash was a 25-sigma event. Put another way: it was a virtually impossible occurrence.

This week's guest EVA comes from our good friend and author of the popular *Things That Make You Go Hmm…*, Grant Williams. We are running this as Part I of II on the subject, with the second-half of the article being presented in next week's EVA.

(Note: Breaks in writing are marked with ellipses)

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NEVER SAY NEVER AGAIN (PART I)
By Grant Williams

Maybe it's a universal truth with a far broader reach, but the role of James Bond is most certainly every British schoolboy's dream.

Weirdly, two of the six men to have played the famous secret agent with the license to kill (sorry, but I'm not counting Barry Nelson or David Niven) have reached a point where they very publicly claimed they would never play the debonair spy again.

Daniel Craig famously told reporters he would "rather slash [my] wrists" than reprise his career-making role as 007 while Sean Connery's battles with producers Cubby Broccoli and Harry Saltzman were so acrimonious (Connery demanded more money to compensate him for the crushing media attention that came with the territory of playing Bond after he was photographed in a bathroom during the making of You Only Live Twice in 1967) that he walked, swearing that he would never again don the tuxedo and sip a shaken (not stirred) martini for the cameras.

However, after very publicly claiming he was done with Bond in 2015 and wanted to move on, Craig found himself plastered all over the media in July when he somewhat sheepishly climbed down (helped off his high horse, no doubt, by a large pile of cash waiting for him on terra firma).

"Instead of saying something with style and grace, I said something really stupid", Craig said when explaining the foolhardiness of his earlier definitive statement about his being done with Bond.

Connery was equally resolute, claiming in 1971 after having been lured back by Broccoli (the producer, not the vegetable) to star in *Diamonds Are Forever*, that he would 'never' play MI6's most famous son again.

…

Definitive public declarations like those made by Craig and Connery are never a good idea but, when all is said and done, an actor going back on such a statement usually involves a very simple, very straightforward, very easy to understand motive: money. Not only that, but it's a stretch to think that anybody's life changed as a result of taking said actor at their word.

However... when it comes to public figures who aren't in the entertainment business, things change very quickly. When those public figures just happen to sit at the head of, for example, a central bank, then the ramifications of such statements take on a level of gravity which makes them positively dangerous.

We'll get back to central bankers shortly (of course), but before we do, let's dip our toes into the dangers of making declarative statements in the financial world with a reminder of a few words uttered by a famous economist from the great state of New York all the way back in 1929.

October, 1929.

October 16th, 1929 to be precise. Nine days before Black Tuesday (or the Wall Street Crash of

1929, if you prefer):

> (*New York Times*): " 'Stock prices have reached what looks like a permanently high plateau,' Irving Fisher, Yale economist, told members of the Purchasing Agents Association at its monthly dinner meeting at the Builders Exchange Club, 2 Park Avenue, last night. Professor Fisher spoke on the subject of investment trusts and presented a defense for them against recent attacks in which they have been charged with responsibility for many present evils.
>
> After discussing the rise in stock values during the past two years, Mr. Fisher declared realized and prospective increases in earnings, to a very large extent, had justified this rise, adding that 'time will tell whether the increase will continue sufficiently to justify the present high level. I expect it will.'"

…

Fisher let his bubbling enthusiasm get the better of him, leading to one of those declarations of belief which, nearly 100 years later, still haunt him no matter how much good work he did in the rest of his career:

> "While I will not attempt to make any exact forecast, I do not feel that there will soon, if ever, be a fifty or sixty-point break below present levels."

Finally, Fisher made a speaker's cardinal sin when prompted to answer a few questions from the audience: near-unqualified optimism. … In reply to one question, he declared that he expected to see the stock market a good deal higher than it is today, within a few months.

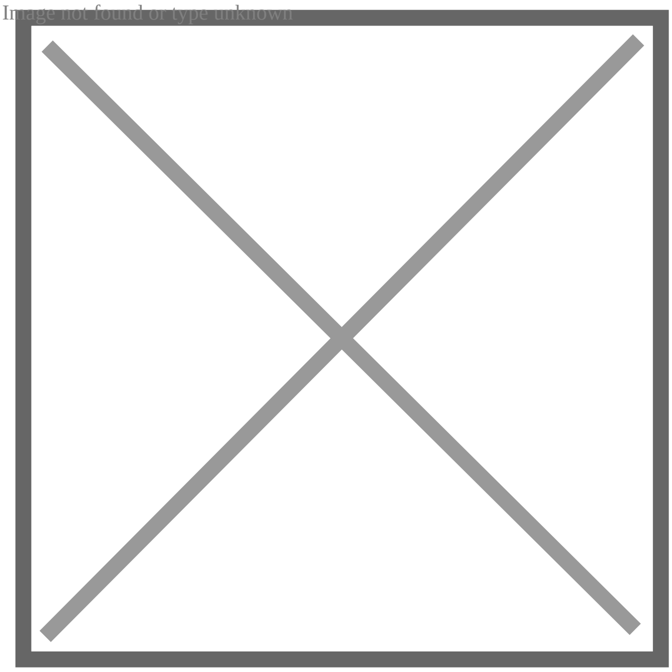
Speaking specifically of investment trusts, and his analysis of their proper value and function, Mr. Fisher said:

> "Largely through the influence of the investment trust movement, the public has been waking up to the superior attraction of stocks over bonds. And I believe the operation of the investment trusts as a whole has acted to stabilize the stock market rather than to make its fluctuations more violent."

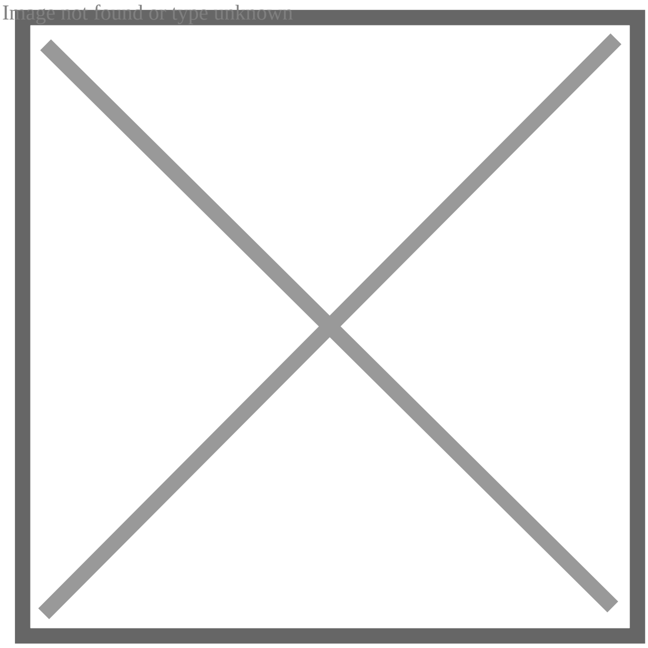
Fisher then explained why that time was different:

> "These investment trusts have applied special knowledge to diversifying risks. They diversify their holdings among many kinds of common and preferred stocks and bonds, foreign and domestic. They operate to shift risks from those who lack investment knowledge to those who possess it. In this way they are safeguarding the public whose speculative activities are gravitating into the hands of these skilled agencies which are able to forecast the true income of otherwise speculative properties."

What happened next is the stuff of legend.



More important than the crash itself, perhaps, is the fact that it took a quarter of a century for the Dow Jones Industrial Average to make a new high.



At the time Fisher made his statement about the ‘permanently high plateau’ (oh Irving... ‘Permanently’? Really? You’re a smart guy, dammit), it would have been easy to nod and accept what he suggested.

The Dow Jones had been climbing for eight years and the index had increased six-fold during that time but, having been made to look foolish by the 11% fall on October 24 (‘Black Thursday’ – just 9 days after his proclamation), the 13% fall on October 28 (‘Black Monday’) and the following day’s 12% decline (‘Black Tuesday’), Fisher declared the slide to be ‘only temporary.’

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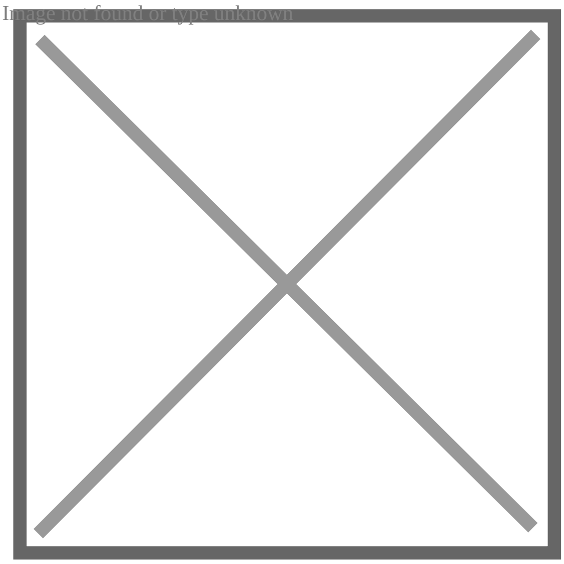
Does any of what Fisher said sound even remotely familiar when pondering the modern-day financial landscape (apart from the blindly optimistic outlook, obviously)? No?

How about now?



Yes, once again speculators have failed to heed what Fisher himself pointed out as the ‘real lesson’ of the 1929 Crash:

> “...if you buy stocks, buy them with your own money and not with borrowed money any more than can be helped.”

Of course, that is the whole point, isn’t it? Investors have been helped – deliberately helped to go into an utterly obscene amount of debt, by almost a decade of zero interest rates. Is it any real wonder that they have been sucked once again into making the same mistakes that wiped out so many people (including Fisher himself) the last time a leverage-fueled speculative frenzy swept Wall Street?:

> (*Time Magazine*): “After witnessing nearly a decade of growth, most economists, investors, and captains of industry believed that the market’s natural direction was up. The beginning of the crash struck them not as a sign of financial doom, but as an opportunity for bargains. Following the first of the black days, the New York Times was full of positive predictions: ‘I have no fear of another comparable decline,’ said the president of the Equitable Trust Company.”
>
> Many of those optimists, including Fisher, went broke by mid-November.

The dates change, the mistakes remain the same.

After making his declarative statement about ‘permanence’ in markets, Fisher (a widely-respected economist in 1929) was exposed as a man who knew as much about the future as every other investor – which is to say nothing – and his reputation was destroyed.

…

However, as ridiculous as using the words ‘permanently high plateau’ were, the sole reason his words are remembered 88 years later is his public profile at the time.

That ought to be enough, right? That ought to discourage other PhD-level intellects from speaking in such absolutes.

In November 2002, another preeminent economist of his time, Ben Bernanke, gave a speech at the National Economists Club in Washington, D.C. in which he too made a declarative statement:

> (Ben Bernanke): “...the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.”

This time, instead of ‘permanent’ it was ‘always’ that the cocksure MIT PhD graduate offered the world.

The same way Fisher had defended his assertions in the wake of the ‘29 Crash, Bernanke, too, doubled down:

> (*The Atlantic*): “...Bernanke defended the Fed’s decision to buy up $600 billion in Treasury securities against critics who claim the action could be inflationary, and said the Fed might purchase more in order to keep interest rates low, ward off deflation, and fuel economic growth.
>
> ‘We’ve been very, very clear that we will not allow inflation to rise above 2 percent,’ he explained, adding that the Fed isn’t printing more money with its purchase of Treasury bonds, as some detractors suggest, and that it can raise interest rates instantaneously if inflation becomes a concern. When Pelley asked Bernanke what degree of confidence he had in his ability to control inflation, the Fed chairman responded, ‘one hundred percent.’ ”

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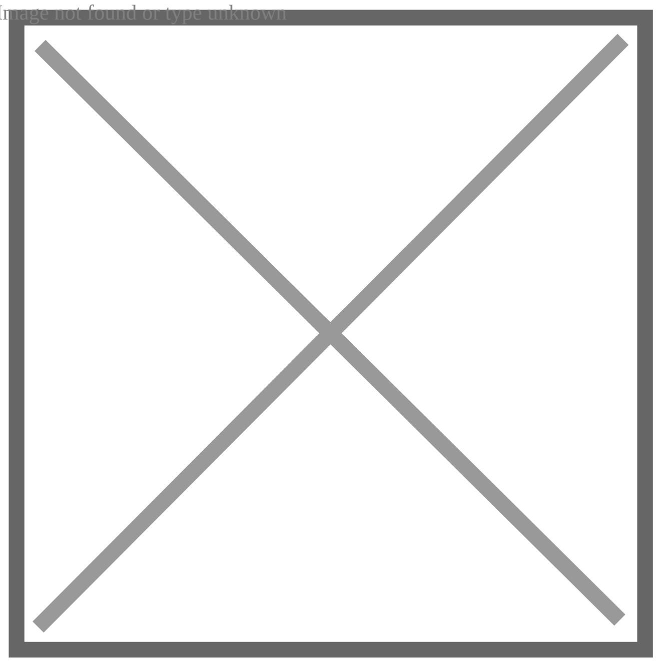


The chart above shows U.S. CPI YoY going back to 1914 – the first year of the Federal Reserve's operation.

To save you some time, I have added a red dotted line to show the level Bernanke was "100% confident" the FOMC would not allow inflation to rise above, as well as a dotted black line showing the 103 year average rate of 3.3%.

Bernanke is widely acknowledged as one of the world's leading authorities on both the Great Depression and deflation (for those of you with the intestinal fortitude, try Bernanke's *Essays on the Great Depression*) so one would be safe in assuming that he has more than a passing familiarity with Fisher's work on debt-deflation (and the development of that work by Hyman Minsky – he of the Minsky Moment).

…

Minsky is something of a hero to post-Keynesian school economists…so you can likely imagine their reaction to the fact that, in Bernanke's nine collected essays on the Great Depression, there is a single reference to Minsky (in Part 2, page 43):

> (Ben Bernanke): "Hyman Minsky (1977) and Charles Kindleberger (1978) have … argued for the inherent instability of the financial system but in doing so have had to depart from the assumption of rational economic behaviour. (1)"

Now, that seems scant justice to Minsky's work (to say nothing of Kindleberger) but the last part of that sentence is highly instructional.

A gentle amble to the footnotes at the bottom of the page in question yields an even deeper understanding of the way Bernanke sees the world:

> "(1) I do not deny the possible importance of irrationality in economic life; however it

> seems that the best research strategy is to push the rationality postulate as far as it will go."

And there you have it.

The idea (which seems widespread amongst the tenured academic economists who sit at the heads of central banks) that irrationality in economic life should be dismissed wherever possible may make the creation of models that much easier, but it does a great disservice to those of us in their thrall.

Boiling it down to its simplest form, investor behavior is governed by the twin emotions of greed and fear – neither of which is rational (OK... fine...I'll accept that rational fears exist. Fears such as being stuck in an elevator with the entire Kardashian family or those weird troll dolls) – so to try and take every possible opportunity to remove 'economic irrationality' from the question is ridiculous.*

*(*Editor's Note: Richard Thaler recently won a Nobel Prize in Economics for asserting the opposite: that consumers and investors often behave most irrationally.)*

However, the fact that Bernanke and his ilk are at pains to try and do that goes a long way to explaining the latest example of this kind of hubristic nonsense:

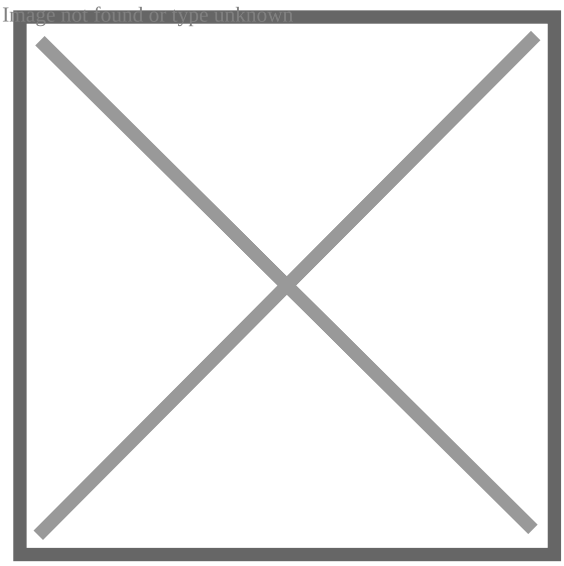
> (*Reuters*): "Would I say there will never, ever be another financial crisis?" Yellen said at a question-and-answer event in London.
>
> "You know probably that would be going too far but I do think we're much safer and I hope that it will not be in our lifetimes and I don't believe it will be," she said.

Yes, I know you've seen that comment and you probably rolled your eyes at it just as I did, but the foolhardiness of such a declaration bears expansion – if for no other reason than the fact that it emanated from the most powerful woman in the world (sorry Theresa but... well, no).

Now, had Janet offered her lifetime as the timeframe in question then, frankly, at 71 a case could have been made, but she chose our lifetimes...and that calls for an entirely different examination.

…

Without rehashing every financial crisis of the last two millennia, if we [look at] the 18th century, we find financial crises occurring in 1720, 1763, 1769, 1772, 1785, 1792 and 1796. These crises encompassed France, the United Kingdom, The Netherlands, Germany, Scandinavia, India and the United States, while the 19th century was a hotbed of financial crises as the table below shows:



The 20th century contained 25 fully-fledged financial and economic crises including a bunch of old favorites like the Panic of 1907, the Great Depression, the 1970s Oil Shock, the Latin American debt crisis and the Savings & Loan Crisis as well as Black Monday, the Asian financial crisis and panics in Finland, India, Mexico, Russia, Argentina (of course) and Asia.

Hell, the 1990s alone saw TEN financial crises.

What’s more, the pace has picked up in the 21st century with 13 individual crises in the first 17 years of the century (and that is extremely generous as it wraps about ten individual national crises into the 2007 - 2009 Great Recession).

The point is, Yellen’s claim that there will be no more financial crises in our lifetimes is utter hogwash.

My firm belief is that the next one will occur while those words of hers are still ringing in our ears and will make her look as foolish today as Fisher did in 1929.

(To be continued next week…)

OUR CURRENT LIKES AND DISLIKES

Changes highlighted in **bold**.

LIKE

- Large-cap growth (during a correction)
- International developed markets (during a correction)
- Canadian REITs (on a pull-back after a healthy recent run-up)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 7%-12% (we like them even more after their recent correction)
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Gold-mining stocks
- Gold

- Select blue chip oil stocks (wait for a pull-back after their recent strong run)
- Mexican stocks (at lower prices after this year's strong rally)
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Short euro ETF (due to the euro's weakness of late, refrain from initiating or adding to this short)

NEUTRAL

- Most cyclical resource-based stocks
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Mid-cap growth
- Emerging stock markets, however a number of Asian developing markets, ex-India, appear undervalued
- Select European banks
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Investment-grade floating rate corporate bonds
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Intermediate-term Treasury bonds
- Long-term municipal bonds
- Intermediate municipal bonds with strong credit ratings
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Solar Yield Cos (taking partial profits on these)
- Large-cap value

DISLIKE

- US-based Real Estate Investment Trusts (REITs) (once again, some small-and mid-cap issues appear attractive; also, some retail-exposed REITs look deeply undervalued)
- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Canadian dollar-denominated bonds (the loonie is currently overbought)
- Short yen ETF (in fact, the yen looks poised to rally)
- Emerging market bonds (local currency)
- Emerging market bonds (local currency)
- **Floating-rate bank debt (junk)**
- **US industrial machinery stocks (such as one that runs like a certain forest animal, and another famous for its yellow-colored equipment)**

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