November 30, 2012

"When is becomes serious, you must lie."
-JEAN-CLAUDE JUNCKER, PRESIDENT OF THE EURO GROUP, THE ORGANIZATION OF EU FINANCE MINISTERS THAT EFFECTIVELY CONTROLS THE EURO CURRENCY

It's been my long-held belief, based on personal experience, that it really is possible to defy the laws of physics. You can actually accelerate time and you don't even need to employ some kind of faster-than-the-speed-of-light travel trick. All it takes is trying to write a weekly newsletter!

Fortunately, for all you EVA readers out there (and I'm pleased to relay that this number has been growing rapidly of late), it's already that time of the month again for our guest edition. In this issue, I thought I'd mix things up a bit by doing more of a "montage" version—essentially, offering brief excerpts from some of the more intriguing pieces I've come across recently.

Unsurprisingly, I'm relying on a couple of Evergreen's favorite go-to sources: GaveKal Research and Grant Williams. While GaveKal needs no introduction to EVA recipients, Grant is a relatively new addition to our portfolio of close allies. For those of you who are truly serious about tracking financial developments around the world, I strongly recommend his weekly e-letter, *Things That Make You Go Hmmm*. As previously mentioned, John Mauldin thinks highly enough of Grant's work to send it out each week to his million-plus subscribers. (You can access Grant's letter via this link.)

In the spirit of full disclosure, I am admittedly imitating a bit of Grant's style by running this montage EVA. At the end of each of his weekly essays, he relays several excerpts from outside sources, including, when he's in dire need of some content, even from yours truly. You'll find a few of Grant's items in the pages to follow.

However, I'm also including a couple of snippets from recent missives I've seen from folks not normally mentioned in EVA, Dennis Gartman and Steven Romick. Then we'll end with one of my favorite "macro" commentators, David Rosenberg.

Dennis is likely familiar to many of you as he gets almost as much airtime on CNBC as Jim Cramer. The difference is that Dennis is right more often than he's wrong. He also pens the very highly regarded *Gartman Letter* from which I am borrowing a brief but fascinating (in a most alarming way) section on California.

Steven Romick is one of the principals at money manager First Pacific Advisers who has worked for years with renowned value investor Robert Rodriguez. Steven runs the FPA Crescent Fund and has been frequently interviewed in *Barron's* and other leading financial publications.

In fact, given that Ron Paul has just made his farewell congressional speech, let's start out with Steven's take on the institution that Mr. Paul loves to hate.

Blind Faith
By Steven Romick

Blind faith has gotten us into trouble repeatedly throughout history. Just consider the rogue's gallery of false idols, dictators, and charlatans we have followed, hoping for something different, something better. That misplaced conviction corrupts and destroys…

Which leads us to the blind faith placed in our current Federal Reserve Chairman Ben Bernanke. Mr. Bernanke told us in 2006 "that house prices will probably continue to rise," and that he did "not expect significant spillovers from the subprime market to the rest of the economy or to the financial system" in 2007. In 2009, he then told us that Fannie Mae and Freddie Mac were "adequately capitalized (and in) no danger of failing," and that the "Federal Reserve is not currently forecasting a recession." And, in 2009, he said, "The Federal Reserve will not monetize the debt." A good education, a deep experience, and a nice title don't make you right. Our leaders in Washington seem to have recklessly accepted Fed decisions that threaten the delicate weave of economy and society.

Despite Mr. Bernanke's poor batting average in predicting the future, his confidence appears unshaken. He continues to speak with the same self-assurance he always has, even though what he thought wouldn't happen did, and what he thought would didn't. He's betting trillions of dollars that he's right—counting on an academic argument alchemizing into reality. If Mr. Bernanke were experimenting in a medical lab, instead of a monetary one, the FDA would require extensive clinical trials proving safety and efficacy before he could release his grand experiment on the American public.

(My note: Steven concludes his Blind Faith essay with the following quotation.)

As the author Malcolm Gladwell so eloquently said, "Incompetence is the disease of idiots. Overconfidence is the mistake of experts…Incompetence irritates me. Overconfidence terrifies me."

The preceding quotation is a perfect lead-in for another example of policymaking hubris, in this case the never-ending disaster in Europe. It was my intent, at one time, to write a full EVA issue called *A Tale of Two I-lands*, contrasting the divergent experiences of Iceland and Ireland since the global financial crisis. Someday I may get to that, but in the meantime Charles Gave has followed a similar path by comparing the post-crisis recovery path taken by Iceland, versus the route chosen by the rest of Europe—or at least that chosen by its ruling elites.

It's becoming increasingly clear to Charles, as well to most of us who recognize reality when it keeps hitting us in the face, that the euro design was, and is, fatally flawed. Yet, those at the helm of the sinking ship *SS Europa*, after having hit several icebergs that have breached its hull, continue to sail confidently north-by-northwest where even greater dangers lurk.

And Meanwhile in Iceland
By Charles Gave

The negotiations over the latest "extend and pretend" deal in Greece is, as usual, focusing on to what degree the economy should be strangled as retribution for past financial sins. According to the logic of the geniuses who created the euro, the population of Greece — as well as Spain, Ireland, France, Italy, Portugal, etc — has to suffer because there is "no other solution."

Roughly at the same time when Greece first started going under, Iceland was blowing up in an even more spectacular fashion. What followed provides an almost textbook study of how to deal with crises brought on by financial excess.

The Icelandic government was fired, new elections took place, the banks were nationalized, deposits in the local currency were guaranteed, and foreign creditors were told that the money they had lent stupidly to the Icelandic banks would not be repaid. The currency collapsed and inflation surged, but this helped bring about needed adjustments: the trade balance moved into a huge surplus, and in time inflation fell and money rates normalized.

Today, Iceland’s economy is growing at a healthy 2.9%, according to IMF (International Monetary Fund) estimates for this year, and unemployment has fallen to about 5% from more than 9%. The IMF is long gone and the remaining loans will be repaid in a few short years, when the last of the capital controls are scheduled to be lifted.

It should be noted that originally the government agreed to pay back its foreign bankers, putting the Icelandic population in slavery for 15 years. A few massive (but peaceful) demonstrations later and the Icelandic president was forced to call a referendum, foreign bankers were told to get lost and the Icelandic people were cut off from the so called international financial community, which is neither a community nor international, but a very well organized banking pressure group.

Now look at struggling Europe today. Unemployment in some countries is above 25%, or more than 50% for the youth, industrial production is collapsing everywhere, budget deficits remain gaping, five countries do not have access to the financial markets, Catalonia is trying to secede from Spain and all the Davos men who built the euro are feverishly meeting in Brussels to devise more useless band-aids for the hemorrhage destroying the old continent.

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In Iceland a popular assembly was created to rewrite the Constitution to make sure the financial system would never again be able to capture the political system. In the euro area, the bankers and bondholders are still calling the shots. When Georges Papandreou, the then Greek Prime Minister, mentioned the idea of an Iceland-like referendum, he was summarily forced out. Southern Europe is being crucified on the euro cross. Without the benefit of write-offs or devaluations, they are sinking into debt traps, or what used to be called "secondary depressions" under the gold exchange standard.

As the German saying goes, better the end of horror than horror without end. Being a passionate believer in Europe, I hope that the financial Frankenstein which is destroying the continent will be thrown upon the dustbins of history, together with the so-called "elites" who invented it. Iceland offers a very tangible proof that a better path does exist.

A recurring EVA theme in past weeks has been the intense desire of Californians, based on the recent election, to emulate the economic policies of southern Europe. Maybe it's because both regions enjoy the legendary "Mediterranean climate." Regardless of the reason, the parallels are unmistakable. Consequently, the erstwhile Golden State is almost certain to see an acceleration of the long-running exodus of its largest taxpayers (suckers?) to less confiscatory venues. According to Dennis Gartman, this is triggering a backlash that is almost Orwellian in its implications.

The Gartman Letter
November 16, 2012
By Dennis Gartman

Things are going very quickly from bad to very much worse in California. It is bad enough that one city after another is going bankrupt given the stupid…the idiotic…the patently ludicrous pensions and salaries given to the fire fighters and police in one city after another…pensions and salaries do beyond the notion of reasonable that cities such as Vallejo have been forced to cut their safety forces simply to be able to pay the pensions of retirees...but now we find that the new state legislature has a Democratic super-majority capable of enacting any legislation it wants without fear of having the Republicans stop it.

The inmates are in control of the asylum as it were and they've proved this with legislation now proposed that shall impose penalties upon anyone leaving California. The wealthy are leaving California in droves, taking their incomes and their wealth with them. They are going to Nevada; they are going to Texas; they are going to Tennessee and to Florida where there are no income taxes in some instances or where the state income taxes are materially lower than are those in California. Listen then to what the new President Pro-tempore of the California Senate, Mr. Darrell Steinberg said regarding this legislation:

It is time to start anew and to live within our means but at the same time invest in the cornerstone of our future and our economy. We need those fortunate enough with higher incomes to continue paying their fair share and if that means making them pay dearly if they decide to leave our state so be it.

This is all the worse in light of the fact that the Democrats have proposed creating a new branch of the state government… the State Team Action to Stem Income…whose duty it shall be to have volunteers around the state inform the STASI if they hear of neighbours who are considering leaving California. For those too young to remember, the STASI was the name given to the former East German Ministry for State Security. One did not "mess" with the STASI in East Germany; apparently no one shall want to "mess" with the STASI in California. We can only hope that this latter bit of news is a joke of course; but at the moment, given the comments by Mr. Steinberg we fear it is not. If the exodus out of California has not been egregious up to this point, it soon shall be. Texas, Nevada, Florida et al must be over-joyed at the stupidity of their California counterparts.

Continuing the theme of arrogance in high places, Grant Williams' in the November 20th installment of *Things That Make You Go Hmmm*, opened his letter by recalling how, back in 1980, Muhammad Ali fooled the world into believing he would pummel his former sparring partner and reigning heavyweight champ, Larry Holmes. (Suffice it to say that "fight" was the final round for the self-proclaimed greatest boxer of all time.) As Grant notes, policymakers in Europe are doing their own version of the deception pulled off by the man who could "float like a butterfly and sting like a bee."

Things That Make You Go Hmmm...
By Grant Williams

Just as, thirty years ago, Muhammad Ali tried to trick the world into thinking he was still his once-mighty self, the politicians and central bankers of the world are desperately trying to trick us into believing the same thing—that once-mighty economies are still the force they were.

They're not.

Whether it's Greece's chances of staying in the euro (they can't), Germany's chances of agreeing to pay for their profligate southern neighbours (they won't), the UK's idea that fictional interest payments are actually real money (they're not), or the US's belief that their economy remains strong (it doesn't)—eventually, reality is going to hit home, and hit home hard.

For Muhammad Ali, the day when reality finally crashed through his carefully constructed facade of invincibility was October 4, 1980. There's no telling when the various days of reckoning are coming to global economies, but one thing is for certain; no matter how hard they try to dance around the issues, no matter how strong we are told they really are, ultimately, the "seconds" will be told to leave the ring, and they will have to stand and fight on their own.

I fear the battering they are in for will be similar to that Ali suffered at the hands of Holmes that night—only this time, there is no referee to stop it.

I will leave you this week with a great observation from JPMorgan's Kenneth Langdon, who had this to say about the coordinated interventions of central banks and politicians in the global economy:

The net result of this partnership between fiscal and monetary authorities is a continuous drain of productive capital from the private sector into the non-productive public sector. Little of that capital will be put to productive use once in the hands of government bureaucrats. As a result of this decimation of capital formation in the private sector, growth will be permanently lower, which in turn creates a negative feedback for the collection of taxes. Major economies are literally being bled to death by this drain of capital from productive uses. Voters are sanctioning this economic suicide.

Amen, Kenneth. Amen.

Some EVA readers may have felt that, along with California, I've been a little hard on France lately. However, Grant ran the following excerpt from a recent feature story in *The Economist* highlighted by this cover.

Based on what *The Economist* observes below, maybe I haven't been critical enough…

Things That Make You Go Hmmm...
November 20, 2012

The threat of the euro's collapse has abated for the moment, but putting the single currency right will involve years of pain. The pressure for reform and budget cuts is fiercest in Greece, Portugal, Spain and Italy, which all saw mass strikes and clashes with police this week. But ahead looms a bigger problem that could dwarf any of these: France.

The country has always been at the heart of the euro, as of the European Union.(EU) President François Mitterrand argued for the single currency because he hoped to bolster French influence in an EU that would otherwise fall under the sway of a unified Germany. France has gained from the euro: it is borrowing at record-low rates and has avoided the troubles of the Mediterranean. Yet even before May, when François Hollande became the country’s first Socialist president since Mitterrand, France had ceded leadership in the euro crisis to Germany. And now its economy looks increasingly vulnerable as well.

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As our special report in this issue explains, France still has many strengths, but its weaknesses have been laid bare by the euro crisis. For years it has been losing competitiveness to Germany, and the trend has accelerated as the Germans have cut costs and pushed through big reforms Without the option of currency devaluation, France has resorted to public spending and debt. Even as other EU countries have curbed the reach of the state, it has grown in France to consume almost 57% of GDP, the highest share in the euro zone. Because of the failure to balance a single budget since 1981, public debt has risen from 22% of GDP then to over 90% now.

The business climate in France has also worsened. French firms are burdened by overly rigid labour- and product-market regulation, exceptionally high taxes and the euro zone’s heaviest social charges on payrolls. Not surprisingly, new companies are rare. France has fewer small and medium-sized enterprises, today’s engines of job growth, than Germany, Italy or Britain. The economy is stagnant, may tip into recession this quarter and will barely grow next year. Over 10% of the workforce, and over 25% of the young, are jobless. The external current-account deficit has swung from a small surplus in 1999 into one of the euro zone’s biggest deficits. In short, too many of France’s firms are uncompetitive, and the country’s bloated government is living beyond its means.

With enough boldness and grit, Mr Hollande could now reform France. His party holds power in the legislature and in almost all the regions. The left should be better able than the right to persuade the unions to accept change. Mr Hollande has acknowledged that France lacks competitiveness. And, encouragingly, he has recently promised to implement many of the changes recommended in a new report by Louis Gallois, a businessman, including reducing the burden of social charges on companies. The president wants to make the labour market more flexible. This week he even talked of the excessive size of the state, promising to "do better, while spending less".

Yet set against the gravity of France's economic problems, Mr Hollande still seems half-hearted. Why should business believe him when he has already pushed through a string of leftish measures, including a 75% top income-tax rate, increased taxes on companies, wealth, capital gains and dividends, a higher minimum wage and a partial rollback of a previously accepted rise in the pension age? No wonder so many would-be entrepreneurs are talking of leaving the country.

My final "mooch" from Grant is a nifty little table he ran providing a numbers-based overview of the fiscal cliff:

Things That Make You Go Hmmm...
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The Boston Globe this week published a simple by-the-numbers guide to the Fiscal Cliff that provides a handy reference for something you are all going to be bashed over the head with relentlessly for the next 8 weeks:

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To wrap up this guest EVA, I wanted to share with you a 10-Point Plan on how to solve the US fiscal fiasco from one of my most reliable sources of cogent analysis, David Rosenberg. As you will read, this is much more about common sense than rocket science.

Breakfast with Dave, How to Fix the Fiscal Mess--Ten Point Plan
By David Rosenberg

1. Do not raise top marginal tax rates on income and capital. This will perversely distort the incentive system. It is not good enough to say the Bush tax cuts were always meant to be temporary—anything that has been around for a decade is pretty well deemed to be permanent.

2. Broaden the tax base. Limit deductions. This is the way to make the tax system more progressive and more efficient.

3. Reduce corporate tax rates. This will help make the overall revenue neutral and help build incentives to invest, which in turn creates jobs.

4. Means-test entitlement programs. Raise contribution rates, again with progressivity a primary goal too. As for Social Security. It is time to raise the eligible retirement age, especially considering that life expectancy is rising by just under one year every decade, and especially since life expectancy is no longer 60 (try 75) as it was when the program was initiated in 1935.

5. Reforms to immigration that allow foreign students to live and work after graduation. This will help ease the skills shortage besetting small manufacturers. Generating more taxpayers is a better policy than raising tax rates on the most successful entrepreneurs.

6. Provide oil and gas development (leasing on public trends; encourage more pipeline expansion; encourage more shale gas development).

7. A national sales tax. Better to tax conspicuous consumption than incomes (Canada has done both this and entitlement returns, by the way. It can be done).

8. Simplify and clarify financial regulation (as Roger Ferguson put in the WSJ, "be careful not to create a one-size-fits-all regulatory environment that could lead to instability").

9. A full-scale war on health care-costs. According to the WSJ, three-quarters of the net $10 trillion in the nation’s debt will be due to the spiraling costs of Medicare and Medicaid. Incentives to contain costs are essential—no more of this fee-for-service. You can’t work on the deficit and not work on this—only 20% of the budget is discretionary, after all.

10. A greater shift in resources towards education and R&D. This will do a far better job in stimulating sustainable job creation than maintaining a system that mobilizes finite taxation resources to the housing market. It would take at least as much political courage to phase out mortgage interest deductibility as it would to implement a national VAT.

Reading the foregoing for the umpteenth time, as I always do, trying to get the content just right, as I never do, an old Biblical phrase popped into my head: "Pride goeth before destruction and a haughty spirit before a fall". Some things never change.

David_Hay_Signature

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