

Sex, Lies, and Inflation

In 'Gia', a film for HBO that launched Angelina Jolie's career, a fashion photographer describes marketing as the art of making a promise that is not going to be kept, and in consumer products, that promise is usually sex.

In government, the promise is usually money - lower taxes for the rich, bread for the poor, circuses for all. Ben Bernanke marketed QE2 as options 2+3 - the circus of reducing long term interest rates, leading to lower monthly payments for the 'middle class'. However, as Commodus finds out in another Hollywood tale, the script of the arena is somewhat unpredictable. Consumer credit, like gladiator fights, is not easy to control. The Fed can deliver free money to banks, but it is up to banks to lower the mortgage, and said banks are not in any position to oblige. Hence central banks control just one economic variable - Inflation. And the only possible direction for the inflation target for QE2 was UP.

What's the Trade Here? Sell Gold + S&P500, Buy Nikkei225 + USD

Recent evidence on the intelligence of central bankers has been unkind. But they knew what they were up to. Lower yields would have been helpful, but were a coin toss; the real objective lay in risky asset prices. Bernanke & Co. believed higher inflation expectations would help companies raise prices and profitability, and this would help raise asset values, lowering the cost of risk capital, leading to more hiring and higher growth as those new employees spend money i.e. asset inflation trickling down to real economic growth. Their stated goals when launching QE2 could charitably be called marketing.

The question then is whether such an effort to raise inflation can succeed, or at least do so without serious damage to the economic system. If so, then global equities are cheap, and gold and oil remain in bull runs. We are here to state that with the exception of Japanese stocks, we have no confidence in this scenario, widely disseminated by the sell side. Forcibly creating inflation is a fool's errand, as it depends not only on the supply but also the velocity of money, in the absence of which inflation and its leading indicator, gold, are shorts and oil is at best neutral at \$100+. The rise in commodity prices historically correlates to a level of supply chain inflation unlikely to materialize. At the same time, the debt ceiling cut amounted to all of \$20bn for this year, nowhere near the 2trillion projected far into the future, creating a long projection of deficits. The combination can leave corporate America in a squeeze, with lower margins compounded by the rising expectation of higher taxes to pay down our debts, and commensurate lower growth, a triple whammy to corporate cash flows. The US market can crater upon this realization, and as taxes from the equity holdings of 'private jet billionaires' go with it, cutting the deficit will become even more urgent.

Some Background - Paradoxically, as we have stated on prior occasions and explain below, the natural state of a world with fiat currencies, a.k.a. paper money, is slight deflation. The 'fiat' part is useless against *rational expectations*, with tail risks ranging from Japan, where printing money failed to create inflation but wiped out the credibility of the bureaucracy, to Zimbabwe, where inflation wiped out the economy. Consistent inflation was an artifact of the Cold War, created by massive spending on entitlements and aid to ideological allies by both sides to convince fence sitters to join their respective systems. To mix some metaphors, even Chicago offered a free lunch in exchange for your 'liberal' soul's commitment to the dark side of capitalism. Victory belonged to the most profligate, but in the end, profligacy was affordable by the system that could create the most wealth. The Cold War ended 20

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years ago, and without that threat, western populations tire of its entitlements, which lingered while eastern / central Europe reformed along free market lines.

So, if targeted inflation is not possible and voters want cuts in spending, what are Bernanke & Co. really going to end up with? The answer from the BEA on July 29 was stunning in its clarity: Not Much. GDP growth in the peak of QE2 washed out.

Technological innovation in a competitive market economy should create, on average, deflation which matches productivity gains, so that even 0% interest rates in effect offer real returns. In a recession, enough additional money supply could be created to insure against deflationary shocks. But at other times this would not be possible, and effectively, central banks lose control of monetary policy. The Bank of Japan prints staggering amounts of money and the only effect is to finance massive deficits and crowd out private activity. Theirs is a quixotic quest to keep inflation consistently above 0, making real returns on cash savings negative, and the only way to attempt that is to pay for inefficiency of overinvestment and a static labor market. By offering negative real returns, central bankers are bent on stealing 1-2% of savings every year to distribute through political decisions.

BOJ has failed, but the policy proves expensive if it gets out of control. Ask older Germans. Or check out the US stock market 1966 – 1982 during the birth of the Great Society and the subsequent loss of the gold standard. Why not cut taxes or even just write everyone a check to do as they see fit? Bureaucrats dislike market based decisions, whether economic or political, and, whether they are led by Brezhnev or Bernanke, the mindset remains the same – they think they simply know better. Just as Brezhnev announced that any democratic reform was bad for all socialist societies, leading to the Prague Spring, Bernanke has decided that any price cut, i.e. passing along efficiency gains to customers in the form of lower prices is bad for the entire economy. He would rather those gains translate into more hiring. If only life were that easy. The results, obviously, have not lived up to expectations.

Until recently, the Bernanke Doctrine extended worldwide. e.g. The Central Bank of India, all protestations of its conservatism aside, has allowed real estate backed debts to roll over indefinitely. Marking to market would require wiping out the capital base of many lenders, which might make their real estate collapse like, well, America's. Such truth would amount to cruel and unusual punishment. So developers quote inflated prices no one pays, while real estate private equity trades at 30% IRR. But existing bank debt rolls over at 12%, allowing everyone to believe in their own genius and in 'land banks'. If you would like to finance construction at 15%-20% call us, we know a few developers who will sign the dotted line.

To allow Asia's real estate speculators, subsidized exporters, and other riff raff to continue their illusion of wealth through the recession, central banks needed to keep money cheap. This is no longer viable because food and fuel inflation leads to riots, or worse, votes for the opposition. Hence rates are rising, reluctantly of course, because the biggest real estate speculators in Asia are the politicians who appoint central bankers.

Under the Bernanke Doctrine, holding stocks becomes a matter of trading inflation expectations because initially, everything goes up or down based on these expectations, but eventually, volatility becomes highly idiosyncratic as a function of sector and firm specific inflation / deflation shocks. Security selection is now a matter of how well a company will be able to manage costs in a world of slower

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growth, or raise prices in response to commodity inflation shocks, or finding, against market expectations, that it needs to pass on efficiency improvements to customers to bring margins in line with those that invite new investment by peers.

A few recent examples of disappointment are

CSCO unsustainable margins

IFN India ETF - central bank behind the curve on inflation

SVU, SYY Food inflation not entirely passed through

FSLR et al solar companies in a tug of war between rising price of oil and falling subsidies and cost / kw

Commodities Offer A False Signal of Consumer Inflation

A side effect of the Bernanke doctrine has been the rise and rise of commodities. However, as the Tea Party digs in to cut deficits, the supply of dollars is suddenly looking smaller. The White House negotiated with itself rather than the marginal bidder, and the marginal bidder ain't BUYING their higher taxes. The Republican party leadership did its darndest to make the Tea Party offer up something from where the Senate Dems would negotiate in the current, i.e. Cold War designed, political framework. However, even a 100+ seat swing in the last election seemingly taught little. The deal to avoid default did very little in reality other than set up for the election of 2012. But this situation is going to turn out badly for Cold War politicians. As a direct result, as the expected supply of dollars from deficit financing available for speculation shrinks, so must the prices of commodities, and for several years until equilibrium is reached. One could hope that another set of bureaucrats across the Pacific learn a lesson and free their own society from the Keynesian disaster that it has become. In the meantime, valuation in Japan's equity market makes one giddy.

For those interested in cash flow valuations, we cover the Nikkei 225 index, ex-financials / utilities.

The Decline and Fall of the Western Liberal-Bureaucratic Complex

Comrade Paul Krugman, writing for the New York Times, would like to convince you of a narrative that goes thus: Western capitalism is squeezing the middle class, and losing its competitive edge vs. China. If we only spent another \$5 trillion we do not have on the 'stimulus' of hiring more government workers or handing out more dole, the problem would be solved instantly. Of course, he sits in an Ivy-clad environment which teaches lesbian studies instead of the political and economic impact of the Treaty of Versailles as a history class, and would like to outlaw Milton Friedman's teachings if it could.

Where we truly are, G7 governments at every level face \$40 trillion in deficits accumulated, with more unavoidable in the near future, and need to get to primary surpluses to pay off debts within a reasonable time horizon. The *only* way this is going to happen, is if the group cuts government spending by 25% from current levels relative to the size of its economies. Today, the European average exceeds 50%. Otherwise, riots are the mildest outcome of such contexts. Wars have begun over less.

Somehow, all this gets blamed on capitalism, or even on Jeffersonian democracy itself. If only we were as efficient as China in decision making or Japan in engineering or whoever today's bogeyman is – and exactly how efficient is that? Would the New York Times like to give the White House the authority to

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order summary executions, at par with the powers of the Chinese Politburo? Or to spend 100% more money than is being taken in, as the Japanese bureaucracy is now doing? (Hmmm, the latter might be true.)

The most important point here is that our intelligentsia somehow confuses the enlightenment with entitlement. As far as enlightenment goes, the east, no matter its cultural and historical advantages, remains decades behind in maturity of political economy and per capita productivity. Almost by definition, creating a fully functional democracy with a billion people that would rival the French / UK model is a task that could easily take a century. That leaves China/ India 50-75 years to go. So the idea that the BRICS can take over superpower or reserve currency status is going to get severely tested quickly.

As far as entitlement goes, forgive me, the best quote comes from Mr. Putin, senior oligarch of Russia, "The government cannot do everything. Believe me, we tried." In the meantime, our liberal-bureaucratic complex, underpinned in the US by the Woodrow Wilson school's philosophy and union financing, came to believe that enlightenment must lead to entitlement. The capitalist system, however, is designed around incentives. And its record of wealth creation at all levels of society remains unmatched in history. As the G7 reaches the limit of its ability to tax, 'progressive' theology faces a great fall such that all the Nobel Prizes and stimulus dollars in the world cannot put it together again. Its promoters have tried mightily to blame this on markets. But the failure lay in the completely irrational bureaucratic risk guidance such as that of the ECB, which gave 'AAA' Greek bonds a lower risk rating than the DAX, or MITI (Japan's Industry Ministry) which spent \$50bn on memory chip technology with nothing to show for it, or our very own Committee on Financial Services a.k.a. Barney Frank & Co, which insisted that anyone who asked for a mortgage loan should get two.

As deficits are cut, in the short term, some companies will lose customers from government belt tightening. But in the long term, this is almost as bullish, if not as necessary, an event as the fall of the Berlin Wall, in terms of the talent reallocated to more productive uses. As regulatory distortions go away, the rationalization of businesses from CECO to MS should lead to a revival of US competitive advantage without the benefit of the Times' advice. But in the meantime, the revenues of any company living off government spending, from Washington area REITs to primary contractors of all sorts, are going to become volatile.

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