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Prologue

Yesterday, Today, and Tomorrow, are the three eras my three-year-old is aware of. He was in mom's tummy Yesterday, he fell at school and got a boo-boo Today; he will attend the big K-5 school next door Tomorrow. I have come to realize, in irritation with the time it takes stock prices to absorb changes in valuation, the equity market thinks exactly the same way. Lehman Brothers collapsed Yesterday, an all but unforeseeable Chinese bank run will bother us Tomorrow, but the Fed is providing easy money Today. Why worry?

Yesterday…. The Gods vs. the Federal Reserve

**Ours is a new generation dedicated more than the last to the fear of indexing and the worship of monetary policy; grown up to find all Gods of value dead, all crashes over, all faiths in free markets shaken. . . .** Apologies to F. Scott Fitzgerald.

I would not have dreamt, sitting in Finance 432, Chicago's flagship class on capital asset pricing taught by now Nobel Laureate Eugene Fama, that I would one day think of multi-factor return analysis as a moral problem. In our faithless generation, there proved very short lived any fear of final judgment, vanished if not vanquished within months after 2008, fear of a situation where Saints Graham and Dodd put you in purgatory for paying 42X Revenues for Twitter, or for having bought Greek bonds at 10 bps over the curve instead of donating the principal to the poor of Bangladesh, where it might have done some actual good. In the meantime, monetary policy as the sole driving factor of returns has made for a world where $25+ trillion of QE has propped up asset markets as stores of wealth, but has done little to move new capital stock into productive activity, which requires an attractive point of entry. In plain English, condos and secondary tech offerings have been used to store the wealth of Indian, Chinese and Russian oligarchs at negative expected returns (since the money is laundered, or worse, default is fully intended on the borrowed capital, who cares?) In the meantime, to legitimate managers, financing the purchase of productive assets makes no sense. Our models, with a somewhat shorter horizon than most DCF valuations, suggest the market is overpriced by 20+%.

http://www.rationalinvesting.com/ETFPortfolio.asp?etf=2&name=%20Spider

Until now, I used to assume the market became more efficient every year, hence it took better models and a larger team to remain competitive. Recently, it seems, the opposite has happened - the global securities market has been assaulted by the US government and its agencies; first by Congress in demanding mortgage lending to the point where money was given away to those willing to lie the most, then by the Fed in printing so much it was given away to those willing to speculate the most. Of course, those capable of doing both well show up on CNBC telling us they worry they are not long enough….

We will look back on the Alan Greenspan - Barney Frank – Ben Bernanke era as one in which the march of rationality came to a grinding halt, albeit hopefully a temporary one. Nobel Laureates now go on national TV to discuss books by French Marxists. Tomorrow (as defined earlier, whether in 2014 or 2018,) we will pick up the pieces, those of us actually attempting to measure risks best as they can, and rebuild faith in markets one tick at a time. Valuations now harken back to the dot com era:

http://www.rationalinvesting.com/WorstRiskAdjustedReturns.asp

http://rationalinvesting.com/Simulations.asp supports our conclusions.

Today…. The Ninth Gate (of the Kingdom of Shadows)

In the movie, the character of Boris Balkan thought he had a deal with the Devil, or at least a clean shot at one, but finds out the Devil is a slippery counterparty, in search of a smarter, if not more attractive alternative to him as protégé. Central bankers are finding themselves in the same position. They think they have struck their bargain of QE to allow the G7 to de-lever at the expense of the risk averse savers of the world, but may find out the devil, just for the fun of it, decided to let the market clear after all. The fine print of the Faustian contract is now become apparent. Some salient side effects:

The same left'ish elite which sanctioned this expropriation also continues to regulate growth out of the G7. Hollande now sell Mistrals to Putin, to be aimed at Syria and Georgia, just to make ends meet, but finds it impossible to cut social charges for corporations or government spending.

Valuations, have climbed to levels not sustained by profit or cost of capital trends, yet trading volumes are at a fraction of peaks. The Treasury market volume is a fifth of normal. The 'whale' was perhaps a stunning absence of liquidity in principal funding markets rather than a miscalculation of value.

China's economy increased leverage during this time by 2x its private production. So did western private equity, and options laden corporate managers.

This leverage flowed into real estate markets in financial centers. New York, London, Miami, Singapore, et al. condos have peaked in real terms for the remainder of our natural lives.

While industrial activity stalled, continued investment in fixed assets in emerging markets, driven by said leverage and rising wages, meant that energy prices rebounded sufficiently to hurt G7 growth. The oil market has slipped into backwardation. For those busy in the peanut gallery in futures class, this means forward prices are lower than spot, more likely a prediction of recession rather than additional supply.

In the middle of all this, the hot war between Shiites and Sunnis and the cold war between China and the US continue to gather steam, with Japan and Russia as the side stories. The Chinese have been drinking a bit of Kool-Aid; what they plan to win by bickering with their largest customer is beyond me.

The Silent Depression

Chairman Bernanke, a keen student of the Depression, managed with Secretaries Paulson and Geithner to fight the 2008 meltdown, but, by continuing to print money helped legislatures worldwide abdicate responsibility for the underlying problem of generating productive growth. We have instead the opposite challenge from the Depression: we have reached the limits of government's ability to tax and interfere in the economy, as various debt crisis from Illinois to Italy and growth crises from India to New Jersey demonstrate. The one lesson unlearned from the Depression is that policy must not hinder private growth, which even social programs revered today managed to do in the thirties.

In the recession of the early nineties, companies were forced to restructure by competition as well as the newly energized market for corporate control, when merger defense lawyers had not yet invented 'poison pills'. By the same token growth sucked up the supply of labor rapidly into new semiconductor technology driven industries. Today, large firms have been regulated into oligopolies, and the government is fighting hydraulic fracturing, the new high tech boom of the US, ignoring an outdated education and training system that leads to 15+% underemployment, and further corrupting the healthcare market, where we already waste more than 5% of our entire industrial and service capacity….

In the Depression, Britain's ability to spend colonial taxes and profits on US goods collapsed as India spun out of control, as the Salt March of 1930 triggered the Civil Disobedience Movement. (Upon cursory examination, 25% of GDP was being extracted out of India as cash crops, including the opium export into China and onwards to the US, while the loss of food production created some side effects….) In the Great Recession, the economic model of spending of money from refinanced mortgages on Asian imports hit a wall. To boot, the US supply chain's profitability is being wrecked by an increase in wages at both ends; note the gap between recent producer and consumer price inflation. The economies that work – Germany, Singapore, Poland – are unique situations which will get copied in part. But the generalized solution of throwing money at the problem is way past its expiration date; money perversely stolen from the real economy to feed financial institutions. Citibank gets away with charging 18% on credit cards while paying zero on deposits. James Bond wishes he had that license.

The Intellectual Bankruptcy of the FOMC

One mid-September Tuesday in 2013, King Willem-Alexander of the Netherlands gave the most important speech of the 21st century. He outlined the notion that the compact between the state and the individual has to change. While he talked about an obscure corner of the west best known today for tulips, tourism and cheese, this was a truth that most elites outside a few US states and Germany cannot yet muster the courage to speak up, if they do indeed understand it. To a greater or lesser degree, the existing level of command and control in all societies was a relativistic outcome of the Soviet age. Yes, the welfare state is almost 150 years old, and yes, the US was more free than, say, India, but every government benchmarked off Moscow in setting targets for welfare spending and political control. Twenty years after the fall of the Berlin Wall, the bankruptcy filing of Lehman triggered the real end of this era, by demonstrating the impossibility of the US mortgage subsidy. There is now an institutional panic in the government-academic complex on how to keep the size of government and the depth of its oversight of the political economy intact, including, amazingly, the subsidy that triggered the crisis.

The Democrats ditched Larry Summers, by far their best candidate to run the Federal Reserve, because he was, like the government of the Netherlands, wont to speak the truth and test the boundaries of ideology. The Federal Reserve, for a while, declined to begin *tapering*. Let's be clear: they were going to reduce purchases from $85bn to $75bn a month, still printing $900bn a year on a balance sheet of 4+ trillion. This crew makes Arthur Burns (the Fed Chair responsible for double digit consumer inflation in the seventies) look good. This was the FOMC's Lehman moment – no I do not refer to September 15, 2008 filing, but the September 18, 2007 earnings call, when CFO Chris O'Mara declared that a circa $1bn write-down and closure of an obscure mortgage processing unit was all the damage done. That was the moment when management could have said, 'There is a real problem, we need to shrink the mortgage book 40% and hit our equity, but this too, shall pass.' Jeremy Irons made confronting the truth look easy in *Margin Call.* No one in the movie suggests making risk numbers up. Lehman Brothers chose to be dishonest, 'beat' estimates, then a year later lamented the government didn't save them.

The Fed has done the same thing. Printing a trillion dollars a year, more than 10% of private production, for six years, can only buy 2% growth while creating another global asset bubble? What if the Fed had bought no assets? Consider the drastic poverty of this payoff. Would we really have been in a 5-year recession? Sure government would have shrunk faster, like many a conglomerate in 1992. One wonders if we might have beaten 2% handily like other recoveries by allowing managers who had not levered up pre-crash to purchase assets at attractive values rather than expropriating their savings at 0%. Yes, tapering is finally on. In the meantime, the S&P was squeezed up another 30%. Now we are at the question of 1999: How high is too high? Where will the momentum stop on the way down?

The Chinese are still hallucinating 7.5% GDP growth, while making commercial research a crime on par with espionage. If their industrial production is growing at 10% as their M2 grows at 50% a year, exactly what is the marginal profitability and whom are they selling to anyway, if their customers are printing $1trillion a year just to reach 2% growth? The press continues to print this rubbish verbatim. After the dot-com bust, many in the fourth estate swore up and down they would not be as incredulous ever again.  Well, then there was the housing bubble, which was supposedly contained, and now it Chinese inflation and ISM numbers, which must be legitimate if they insist on repeating them ad nauseam.  No wonder Rupert Murdoch shut down *News of the World* and bought the *Wall Street Journal* - the real scandal Today is at the Chinese Ministry of Commerce, not at parties of Manchester United WAG's.

The South China Morning Post (which Mr. Murdoch's News Corp. seems to have a residual stake in) recently printed an MBA student's paper describing how Chinese inflation is rigged.  Sometime in the near future, Skynet will become sentient, markets will realize there is chaos at the top of the global bureaucratariat; someone more credible than a graduate student will dare sign a document describing how housing costs are undercounted in Beijing's inflation statistics.  This loss of ability to control the truth is leading to a fracturing of governments unlike anything since Gorbachev gave up control of the Soviet Empire.  But in a twist to the Hollywood tale, at the nodes of the network are human citizens beginning to push back at governments, who are looking around for Terminators.  They have found Janet Yellen.

Tomorrow….  The End of History

So we need to grow shale drilling in Europe, banking in rural India, women's employment in Japan, etc. etc. How quickly can all this really happen?  In India, the right man is on the job at the Reserve Bank. Occasionally history chooses someone to take a crack at improving the lives of a billion people.  I, for one, have high hopes in Raghuram Rajan.  The election of Mr. Modi gives him room to reform banking. The White House, meanwhile, is being ripped apart by the repeated scandal of management by political hacks from Chicago, the city, (determinedly) not the University.  As for France, a generation of elites is proving clueless, their policies making the Maginot line look good.  Someone is needed at the top who is up to a street fight with the unions and can finally put the ghost of the guillotine to rest.  The Japanese are enjoying the relief of a devaluation which, if unreciprocated, catches up with their competitors, while the Germans are beginning to face the reality of over-reliance on China.  Russia and the Middle East will find growth hard given those forward oil prices and strife along their geopolitical fault lines. History somehow refuses to end in the liberal democratic nirvana Francis Fukuyama envisioned in 1989.

One way or the other, a movement of capital from financial to real markets is desperately required. Prices proved highly elastic to the supply of cheap money as a proxy for future economic growth.  But markets will not hold up as expected returns turn negative, especially as the marginal lender, the People's Bank of China has decided to improve returns of its own depositors.  That change of tack combined with slowing demand is the definition of a hard landing.  For the outcome, one need look no further than the Nikkei since 1989.  As the research paper by Fama and Miller (1978) stated, the marginal bidder in a market sets the price.  In US equities, that marginal bidder is one Jeremy Grantham, of GMO in Boston.  When he publishes a statement saying 'the market could go on for another 20%, but I'm taking the other side of the trade', do what he does, not what he says.