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Carrying a cat by the tail

By Tony Deden

It was recently estimated that the size of worldwide financial assets exceeds $80 trillion, or more than twice what it was 10 years ago. Even allowing for all the double- or even triple-counting of all the leveraged toxic waste that passes for assets, the number is staggering. To find such a rate of growth during a period of seemingly permament economic stagnation is more staggering yet. In the midst of this financial explosion, imagine this: in well-appointed offices around the world, scores of well-educated and intelligent folks sit in front of Bloomberg terminals running sophisticated spreadsheets of considerable mathematical complexity, earnestly seeking to somehow find some marginal yield and rationalize the premium they expect for supplying "capital." One wonders whether any one of such folks, or their customers, ever reflects on the premium they ultimately pay for mere hope.

For decades, the bonds of major industrialized countries were considered risk-free investments and were counted as capital, as collateral and as the foundation for creating countless layers of further leverage and speculation. Everything was given its own CUSIP or ISIN number and everything counted as a security and as an asset at the books of banks, brokers and pension funds. As long as someone had a bid, just about anything, however imaginary, counted as an asset. Indeed, the sorts of assets that have rendered the banking system insolvent and broke are nothing but a medley of this staggering financial pyramid.

Unavoidably, a big part of this unimaginable $80 trillion represents liabilities in the form of savings, future pensions, insurance obligations and hopes of so many who blindly (or not) trust the folks that sit in front of these Bloomberg terminals and the government employees of all sorts, some of whom come with brilliant pedigrees in economics, who claim to somehow regulate and supervise their activities. Mark Twain once quipped that "a man who carries a cat by the tail learns something he can learn in no other way." It's been two generations since the whole world learned the same lesson.

More and more frequently, we hear about so many investors who don't quite know where to turn. Politicians are confused and surely, as Orwell once explained, stupidity has become their only escape. The amoral bankers are lost and broke. Somehow, despite mountains of money, massive interventions and dazzling central planning, things are not working as they should or as expected. Yet so far in 2012, more junk bonds were issued than at any time since 1980. Clearly, one knows that the difference between what once was junk and what was investment-grade has now vanished. What remains, notwithstanding the bond ratings agencies, is the desire to find something safe—even relatively so. But an unassailable problem persists, that is, that so little of this $80 trillion in "wealth" is real, productive, economic or tangible. It is mostly a mountain of debt built on debt which is built on credit.

Despite the best intentions or endless talk about engineering growth, refinancing, austerity and other solutions, such debt, whether denominated in dollars, euros, sterling or yen, can never be repaid. We have come to the end of the road even as we

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don't know how the end is likely to come or when. Some 10% inflation for a dozen years or so will likely solve the problem and so would an outright default. A revolution here and there is likely to speed things up and a major war could well be in the cards. People may not know where to turn because, simply, there is nowhere to turn. Neither do they notice the seeds of political repression that are sprouting in civilized places everywhere. But most importantly, in their desire to get things back to normal, the men in front of the Bloomberg terminals and their customers have failed to conclude that the game has changed and they keep miscalculating the premium they put on hope. It's never been so large.

What price for freedom?

Sometime in 1760, Venture Smith, a slave "resolutely determined to become free," purchased his freedom—with his own savings. After all, in free markets, most everything is really a matter of price. Well, then, if Mr. Smith could buy his freedom from slavery, why is it not possible for us to buy our freedom from the slavery of taxation? Far-fetched? ***Dominik Schönenberger*** *thinks this is the real market solution to the debt woes of governments. He writes:*

How much longer can our governments remain this indebted? With tax revenues insufficient to cover expenses and leaders still clamoring for spending today rather than saving for tomorrow, it is no wonder that states are largely funded with debt. But there is a better way. There are some people with a lower time preference who stand willing to forgo the benefits that governments are struggling to pay for.

The government should offer citizens and companies a way to buy their freedom from taxes. Against a one-time payment, they would be relieved of the obligation to pay a specific tax, relinquishing in the process any rights they would otherwise have gained.

How about being relieved from compulsory health insurance against a one-time payment of CHF 20'000? Henceforth, you could take care of yourself within your own means. Are you interested in freedom from compulsory unemployment insurance or retirement plans? In the view of some citizens, such services are meaningless, and a *Freikauf* would be interesting to them.

How about a lifelong exemption from income tax? How much are you willing to pay for never again having to pay tax on the first CHF 100'000 of annual income? Is it worth CHF 50'000? CHF 80'000? (Of course, the tax-exempt amounts would have to be adjusted to inflation. We certainly do not want to create yet another incentive for inflationist policy.)

Such purchases of freedom would also be in the interest of the indebted state. The eyes of politicians are already gleaming at the prospect of *instant money now*. In addition to receiving an immediate cash influx, the government would be relieved of providing costly services to those who have opted out. It would be downright irrational for the government to turn down such a deal—at the right price. It is simply a matter of price.

The supposed "solidarity" of taxes would not be affected by such transactions. The freedom seeker is not magically exempt from taxes; instead, he makes a substantial one-time payment to the government and abstains from receiving future services or benefits. In fact, such an action represents true solidarity because it is voluntary. This is not the case with taxes—which are enforced with violence and threats and have nothing to do with true solidarity.

But what about freedom buyers who become impoverished later in life and can no longer afford expensive healthcare? To avoid the necessity of the government stepping in to resolve such a situation, one's acquired freedom could be conditional upon the preservation of a certain amount of wealth, to be evidenced annually. Consider that such an annual demonstration of wealth is already required by the tax codes of Switzerland and many other countries. As soon as one's savings fall below a certain limit, the freedom buyer could again be forced to become insured under government healthcare programs, and may have to pay a contractual penalty. (There is of course a case to be made against such compulsory programs in the first place, but the deals proposed here are still a marginal improvement.)

Would such freedom purchases create additional bureaucratic burden? Yes—but the costs would be borne entirely by the freedom buyers who enter the contracts voluntarily and individually. For once, bureaucracy would operate in the name of freedom.

We read

"Your Excellency, if I were you, I would say 'let this awful country go to hell.'" Such is the advice of one Thanos Tzimeros in his Open Letter to the German Chancellor Angela Merkel. None of the newspaper articles, commentaries, editorials and expert analyses on Greece comes even close to Mr. Tzimeros in his damning description of a failed state and the implications for the future of its people. Those prescient among our readers will undoubtedly see similarities between Greece and other, perhaps larger and more powerful nations.

Read the article here: http://tinyurl.com/ej-tzimeros.

The Buffett-Munger octogenarian duet of incoherent pronouncements as to what "civilized people" do with their money does not seem to have made much of its desired impact. Civilized people are at a complete loss as to the safety of their money if not the nature of what *is* money. Addressing his clients in his First Quarter report, David Einhorn, the chief guru at Greenlight Capital, is not beyond a little tongue-in-cheek at the expense of the delirium from Omaha:

"The debate around currencies, cash, and cash equivalents continues. Over the last few years, we have come to doubt whether cash will serve as a good store of value. If you wrapped up all the $100 bills in circulation, it would form a cube about 74 feet per side. If you stacked the money seven feet high, you could store it in a warehouse roughly the size of a football field. The value of all that cash would be about a trillion dollars. In a hundred years, that money will have produced nothing. In a thousand years, it is likely that the cash will either be worthless or worth very little. It will not pay you interest or dividends and it won't grow earnings, though you could burn it for heat. You'd have to pay someone to guard it. You could fondle the money. Alternatively, you could take every U.S. note in circulation, lay them end to end, and cover the entire 116 square miles of Omaha, Nebraska. Of course, if you managed to assemble all that money into your own private stash, the Federal Reserve could simply order more to be printed for the rest of us."

CERN, the big physics outfit in Geneva, recently announced that it has allocated $500 million of its $4 billion pension fund to hedge funds. It wasn't too long ago that the Church of England pension fund also decided to double its own allocation to hedge funds. In the case of CERN, however, the trustees were quoted to have made clear they had "no tolerance for losses." Good luck to the scientists and clergymen, for once united in their hope for miracles and magic. Despite evidence to the contrary, at Two and Twenty, the black-box mystique coupled with sleek powerpoints is just too much to resist on the road to ruin.

Switzerland's *Neue Zürcher Zeitung* reports that Swiss bank regulators are thoroughly confused as to what constitutes bank capital. "How solid is the capital cushion of the big Swiss banks?" it asks. Well, "the trouble begins with definitions." Indeed. What exactly is capital? And going to the heart of the matter, it adds: "The computational models for assigning risk weights are unreliable." Depending on such models, the capital ratio of, say, Credit Suisse, could be as high as 18.7% or as low as 1.7%. Use your own model and take your pick. And, by the way, the numbers exclude off-balance sheet obligations. And it isn't just Credit Suisse. It's every one.

Read the article (in German) here: http://tinyurl.com/ej-nzzbanks.

At a time when the word *tech* is synonymous with the supply of devices whose only purpose is to feed the narcissism of modern man, we delight to see the kind of tech that does not make for headlines—that which improves a nation's capital stock and generates the kind of real productivity that results in enduring gains in the standard of living. Of many examples we can cite, here is a nice one: how is a cattle farmer to know that one of his cows is ovulating and fertile? By receiving a text message direct from the cow, of course.

Watch the video: http://tinyurl.com/ej-cows.

Roger Köppel, the editor and publisher of Zürich's outstanding *Weltwoche*, is a rare example of a journalist that has moral courage *and* can think for himself. Unlike his peers, instead of cuddling Nobel laureates in economics and the many assorted idiots of our time who pass for experts, he sees no problem in addressing issues about which his contemporaries remain ignorant. In a recent editorial he writes: "Crises are part of the market economy. They are the consequence of human characteristics such as excitement, exaggeration, fear, profit-seeking and

herd instincts. During a crisis, reality penetrates the illusion created by humans. This is healing. Crises must be allowed to run their course in order for the economy to normalize. Whenever attempts are made to prevent or repress a crisis, the entire system will collapse eventually. Socialism lived for 60 years, seemingly without crises, but then it collapsed. But never has a state died because of too much market economy."

We hope that Mr. Köppel will eventually also see the connection between central planning, intervention, dishonest banking and all such crises. A little Swiss revolt could be the beginning of great things.

Read the whole article (in German) here: http://tinyurl.com/ej-koeppel.

Britain's exchange rate is "crippling" the economic recovery, says an article published by Bloomberg. Since 2008, the British pound has lost 25% of its value against the US dollar and 70% against the Japanese yen—but according to Civitas, a UK research group, even this isn't enough to "spur growth" and become competitive. "A lower exchange rate is needed," says John Mills, the author of the report. "Getting the exchange rate down is a matter on which, in the end, we will have no choice." And why not? Everyone wants a lower exchange rate. From the Swiss to the Japanese and everyone in between, the chorus for currency devaluation resonates loudly. Except for just one simple thing: It doesn't work. Think of it this way: if such a simple idea did work, where has Robert Mugabe gone wrong?

"I have watched the most able men and women of my generation, who might have created unexampled monuments in moral philosophy, mathematics, or engineering, waste their time in prattle of non-accelerating inflation rates of unemployment or rather, since such matters cannot long occupy an educated mind, in interminable telephone conversations with their stockbrokers. ... [E]conomics has retreated into algebra. A profession that begins with priests [alchemists] ... ends with hermits. Political economy is now, I suspect, in the same condition as scholastic learning found itself on the eve of the Discoveries. It is about to explode."

—James Buchan, Frozen Desire: An Inquiry into the Meaning of Money *(1997).*

"In his great treatise—*An Inquiry into the Nature and Causes of the Wealth of Nations*—[Adam] Smith asked, what have been the traditional means of combating poverty throughout history? The answer, of course, was government. People had always believed that governmental policies were necessary to ensure that people did not starve to death or suffer lives of impoverishment. Yet, despite the best efforts of governmental officials throughout the ages—such as with the English Poor Laws, the Corn Laws, price controls, and antispeculation laws—people had continued to suffer deep privation.

"Smith's conclusion was a revolutionary one—and one that did not find a ready audience among public officials. Smith concluded that throughout history, *it had been governments' attempts to defeat poverty that had prevented nations from becoming wealthy and prosperous*. That is, government itself—through its taxing and interventions into economic activity—was the source of the privations and sufferings that had afflicted mankind throughout the centuries. If government was prevented from attacking poverty, Smith argued, people would prosper! In other words, once the heavy burden of taxation, subsidies, and interventions were lifted, a nation would enjoy wealth and prosperity."

—Jacob G. Hornberger, "Classical Liberalism in Argentina: A Lesson for the World" (1994). Emphasis his. Read the essay here: http://tinyurl.com/ej-hornberger.

"Ask enough people for advice, they say, and you will eventually find someone who will tell you what you want to hear. But the need for advice burns so strongly that people become blind to its quality. There is a remarkable tendency to trust experts, even when there is little evidence of their forecasting powers. ... The more prominent the expert (i.e., the more they were quoted by the news media), the worse their records tended to be. There is also an inverse relationship between the confidence of the individual forecaster and the accuracy of their predictions.

"... Perhaps the financial-advice industry survives because the idea that the future is unknowable is just unsatisfying. Some forecast—any forecast—is therefore comforting. Mr. Tetlock suggests that 'we believe in experts in the same way that our ancestors believe in oracles; we want to believe in a controllable world and we have a flawed understanding of the laws of chance.'"

—The Economist, 9 June 2012, http://tinyurl.com/ej-experts.

"Jeremy Grantham is a paradox. A man who has said many times, '*This time it's different* are the four most dangerous words in the English language,' is now saying—loud and clear—this time it really is

different." Mr. Grantham thinks that one particular "failing of capitalism" is its "propensity toward short-term thinking" which "is severely impairing our ability to adapt." Oh, Mr. Grantham, knowledge without perspective can be quite cruel.

Read the essay by Michael Edesess here: http://tinyurl.com/ej-edesess.

"Strange times and fundamentally distorted markets require investors to possess unusual psychological fortitude. Two things are required to maximize the probability of meaningful capital growth or simply capital preservation in real terms within such a perilous environment. One of them is an attractive valuation at the inception of an investment. Pockets of value undoubtedly persist throughout debt and equity markets, though one may have to look harder than normal to identify them. (We leave momentum investing to others.) The other is patience. An easy philosophy to articulate, but a fiendishly difficult path to follow."

—Tim Price, "The politics of fear," PFP Wealth Management commentary from 30 April 2012, http://tinyurl.com/ej-price.

"Managing a portfolio is, as I've written before, like driving a car very slowly through thick fog. However, I was impressed by a recent comment by my old friend Alex Hammond-Chambers, one of the original directors of Personal Assets when it was floated in 1983: '*Ask yourself why so few fund managers saw the financial crisis coming. The answer is, they weren't looking. Macro risk assessment wasn't part of their style; like the driver of a car who keeps his eye firmly fixed on the few yards ahead of him, he is unable to see an oncoming accident*.'

".... The politicians and central bankers, terrified of a depression, have intervened again and again to prevent the market from finding its proper level. If pain is to come, it is more likely to be lasting and chronic than sudden and acute, and is most likely to be inflicted on investment returns by inflation. Some readers like my Latin tags and others loathe them, but the effect of inflation on investment returns is beautifully described by this medieval adaptation of a phrase from Ovid: *Gutta cavat lapidem, non vi, sed sœpe cadendo.* 'A drop of water hollows out a stone, not by force but by frequently dripping.'"

—Robin Angus, Chairman of Personal Assets Trust Plc in a recent letter to shareholders, http://tinyurl.com/ej-angus.

Exploring the range of solutions to the financial mess in which we live, Charles Hugh Smith thinks that austerity will not work. "That which is painful to those collecting free money will be avoided, and that which is easy will be pursued until it's painful," he writes. He then surmises that on account of ideology alone, "solutions that turn off the free money spigots are non starters" that result in "political disunity and gridlock." Ultimately then, the only solution is "collapse." He fails to mention the in-between repression which is certain to come our way, but comes to the same conclusion as other learned observers, that is, that a collapse of the existing order, monetary and otherwise, is unavoidable.

Read his article here: http://tinyurl.com/ej-smith.

"The banks have to suffer and suffer badly. They will have to suffer in such a way that in a decade they will be scared in order to never behave in this way again. You have to reduce the financial sector to about one third of its current size and we have to also ultimately set up financial institutions and financial instruments in such a way that it is no longer desirable from a public point of view to borrow and gamble in rising assets processes.

"The real mistake we made was to let this gambling happen as it has so many times in the past, however, we let it go on for far longer than we have ever let it go on for before. Therefore, we have a far greater financial parasite and a far greater crisis."

—Steve Keen, interview on 8 June 2012, http://tinyurl.com/ej-keen.

Networking seems to have become the modern professional's most purposeful endeavor. It is the idea of getting to know as many people as possible, managing contact details, publishing one's affairs on Facebook, Twitter, LinkedIn and so forth. It springs form the notion that the more people we know, the higher the chances that an otherwise rare opportunity will someday surface which will hasten our success. In such zeal, the means have become the end. It is the kind of activity that some of us avoid as if it were the social equivalent of the Ebola virus. We are not alone. In his book *Extreme Money*, Satyajit Das writes: "Don't network. Focus on building real relationships and friendships where the relationship itself is its own reward, instead of trying to get something out of the relationship to benefit your business or yourself."

As it happens in the beginning of every year, we have been carefully perusing countless annual reports of various companies. We find something quite puzzling, perhaps more so than in prior years. For all the corporate crap, legal notices, *mea culpas*

and other nonsense that finds itself into the pages of annual accounts, we can't help but notice the frequency in the use of the word *sustainability*. We profess that we don't quite know what it means other than the claptrap political correctness in which it is offered. And let's not forget the use of "corporate responsibility." As investors, we can identify with the ideas of "enduring value." *Sustainability* is alien, vulgar and presumptuous. In fact, with the help of Google Ngram, we find that the use of this world did not even come into the vocabulary until the 1980s or so. Same goes for the corporate responsibility bit. Perhaps, somehow, the less we have of something as a society, the more we talk about it.

Books we read

By Otto von Schwamendingen

Why Nations Fail is the title of the lavishly praised recent book by two academics: Daron Acemoglu (MIT) and James Robinson (Harvard). It is impressive if only on account of its range, ambition and incredibly rich historical examples. Its topic, the subject of many inquiries on political economy, it is also the kind that sells books—especially when it comes with a presumptuous title. Among others, not too long ago, Jared Diamond made a small fortune with his *Guns, Germs and Steel*, despite the gross charlatanism. As to why some countries are rich and some are poor, Diamond's answer was geography. His arguments were ingenious but wrong. On the other hand, Acemoglu and Robinson argue that the answer is politics or, rather, the presence of political institutions, that is (in their view), property rights, economic freedom, equality before the law, the sanctity of contracts and so forth. They argue that the free markets are insufficient on their own to make a difference. If an economy is to prosper, they suggest, governments are the only ones who can and must supply such institutional advantages.

Sadly, the authors' enormous and ambitious undertaking ends up with answers that confuse cause and effect—an elementary but common intellectual trap. Political correctness avoids a crucial and necessary component in the understanding of economic development: inequality. Not only are we born unequal in every respect but we do tend to labor with unequal effort, objectives and time preference. We seek to alleviate the gap in wealth that separates rich and poor without the understanding that such division is a historic and long-standing problem.

"In the pursuit of wealth, failure or success are ultimately determined from within, not imposed from outside." So writes David S. Landes, a Harvard historian whose striking and iconoclastic 1998 magnum opus *The Wealth and Poverty of Nations* remains my favorite on the subject. "If we learn anything from the history of economic development, it is that while many have become rich over time, the security and permanence of wealth in a society is a function of the appropriate cultural traits." Reviewing the book for the *New York Times* in 1998, Andrew Porter summarizes Landes' thesis on prosperity as "the product of a society that had developed a sense of national cohesion; a capacity to compete; a respect for, and a concern to impart, empirical and technical knowledge; and a preference for advancement by merit or competence." Such a society's members "had the ability not just to acquire but to use money, they respected honesty, and their institutions provided security both for property and for enjoyment of the rewards of labor or enterprise." That is, as he argues, government is the *result* of a culture and not the source of its traits.

To gain a meaningful understanding of the political and economic issues that dominate the news, whether in Greece, Spain, Germany, Europe in general or, by inference and reflection, even the United States, one ought to start with political economy and history. Only as a start, we have two recommendations:

David S. Landes, *The Wealth and Poverty of Nations: Why Some Are So Rich and Some So Poor* (W. W. Norton & Co, 1999). It is in stock at Amazon.com.

Erik von Kuehnelt-Leddihn, *The Intelligent American's Guide to Europe* (Arlington House, 1979). Unfortunately, this book is out of print and difficult to find.

SENSE AND NONSENSE

- "The French are a free people, who will not allow their future to be determined by the pressure of markets or finance."
  —French presidential candidate François Hollande, 19 April 2012

- "When it becomes serious, you have to lie."
  —Jean-Claude Juncker, Luxembourg Prime Minister and Head of Eurozone finance, unintentionally describing the principal governing tool of the whole EU mess, 9 May 2011

- "We have to restrict freedom of choice. It leads to the demise of civilisation."
  —Biologist Paul R. Ehrlich interviewed by NZZ am Sonntag

- "The Euro is the problem, not the solution. ... Why, as the euro crisis deepens, do the media keep turning for analysis to the people who have been consistently wrong until now?"
  —Daniel Hannan, Member of the European Parliament

- "In the long term, preserving one's assets in real terms is already a success."
  —Friedrich von Metzler, Head of Frankfurt's 350-year old Metzler bank

- "I feel like I'm having a black tie dinner on top of a volcano, okay? That volcano is China."
  —Johann Rupert, CEO of Richemont in the Q1 conference call on 16 May 2012

- "The state is the solution. When there is recession and economic crisis the state becomes a key actor in revitalizing demand and production."
  —Axel Kicillof, Argentine government economics adviser and devoted admirer of Keynes and Marx

- "It felt like a divorce from a violent husband."
  —A woman after renouncing her US citizenship, as reported (in German) here: http://tinyurl.com/ej-divorce

- "Information without perspective is the highest form of ignorance."

- "How Much Gold Do Investors Need? Zero Should Suffice"
  —Title of a recent Wall Street Journal *article*

- "When people ask: might we become Japan? I say: I wish we could become Japan."
  —Paul Krugman, at a lunch with FT*'s Martin Wolf, 26 May 2012*

- "Why are you guys so anti-dictators? Imagine if America was a dictatorship. You could let 1 percent of the people have all the nation's wealth. You could help your rich friends get richer by cutting their taxes and bailing them out when they gamble and lose. You could ignore the needs of the poor for health care and education. Your media would appear free, but would secretly be controlled by one person and his family. You could wiretap phones. You could torture foreign prisoners. You could have rigged elections. You could lie about why you go to war. You could fill your prisons with one particular racial group and no one would complain. You could use the media to scare the people into supporting policies that are against their interests."
  —Sacha Baron Cohen's film "The Dictator"