

# THE RICHEBÄCHER LETTER

*The Monthly Missive of The Richebächer Society*

NUMBER 417

JUNE 2009

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*“If we’re going to finance budget deficits by printing money, we may have high inflation, even risk of hyperinflation in some countries. That’s what happened in Germany in the 1920s during the Weimar Republic. We are having large budget deficits and increasing the public debt, we don’t know whether it’s going to be \$5 trillion or \$10 trillion of more debt. But there are only a few ways of resolving that debt problem: either you default on it as countries like Argentina did; or you use the inflation tax to wipe out the real value of the debt; or you have to raise taxes and cut government spending. And given the size of the deficits, over time that’s going to be a painful political choice to make.”*

— Nouriel Roubini, June 11, 2009

## GIMME BACK MY BUBBLE

Decades ago, Ben Graham taught Warren Buffett an invaluable and timeless lesson about Mr. Market. Mr. Market, it turns out, suffers from manic-depression, although everyone politely pretends otherwise. He is always ready with a price quote for financial assets, but unfortunately, he is also strapped into an emotional roller coaster from which escape has proven nigh impossible.

On the days when Mr. Market is engulfed in confident, euphoric feelings, his evaluation of financial opportunities is similarly rose-colored. He bids high and he is reticent to sell. On the days when Mr. Market is swamped in the undertow and riptide of despair and doubt, he sells low and is very reluctant to buy.

Ben Graham’s advice was simple: Mr. Market exists to serve you, not to guide you. Recognizing Mr. Market’s congenital affliction, the best thing you can do is get a clear understanding of the fundamental value drivers of your investments and then pick Mr. Market’s pocket, not his mind. Profit from Mr. Market’s folly, rather than participate in it, was the pearl of wisdom that Ben Graham left for Warren Buffett.

From the perspective of many of academia’s greatest minds, Ben Graham’s advice is sheer blasphemy. Financial markets, they believe, are efficient processors of information. Efficient-market theory holds that asset prices already reflect all known relevant information. There is simply no point in looking for \$20 bills on the sidewalk: They have already been pocketed. On this theory, Warren Buffett cannot exist, or at least he certainly cannot exist as a successful investor... but don’t tell Warren; it might ruin the rest of his career.

In contrast, from the perspective of many institutional investors who cut their teeth on the dot-com bubble, followed by the housing bubble, Ben Graham’s advice has career risk written all over it. They learned the trend is their friend, and they know they are paid to play. Daring to question Mr. Market will certainly leave you in the dust if playing momentum is the name of the game. It is fair to say Dr. Richebächer was more inclined to side with Ben Graham than with either the academics or the more momentum-oriented crop of institutional investors, and that is an orientation we intend to preserve. By the same token, we have no desire to fall prey to a knee-jerk contrarian approach to macro and markets.

## A PRACTICING PICKPOCKET

When we took up *The Richebächer Letter* late last spring, we argued many investors were fooling themselves by ignoring the mounting evidence that the economy was already heading into a recession. Commodity prices collapsed later in the summer as this recognition spread, with equity investors catching on later in the fall. Mr. Market was too

complacent back then, and our read on the fundamentals suggested we best pick his pocket by selling riskier assets to him.

Applying Dr. Richebächer's approach and adapting some of the insights from the economists that influenced his thinking, we further concluded the global economy was unlikely to get away with just a garden-variety recession. Rather, our analysis led us to believe the risk of a debt deflation scenario was uncomfortably high, and we began investigating the likely policy responses that might be deployed in order to contain this risk.

While we did not foresee the Lehman Bros. debacle, the degree of leverage in the financial sector itself virtually ensured that Bear Stearns' blowout was unlikely to mark the apex of this financial crisis. Nevertheless, Lehman Bros.' collapse unquestionably quickened debt deflation dynamics, and the subsequent policy response has been nothing short of desperate. Mr. Market entered into one of his more terrifying funks, lasting well into early March.

Chinese equity investors were the first to conclude that extreme policy response would successfully contain the downside risk from imploding global trade, and the Shanghai index, as of this writing, is up over 45% year to date. U.S. and rest-of-world equity investors kept staring into the abyss until early March, and then performed, en masse, an about-face. Still, most major U.S. equity indexes remain near flat year to date.


The trigger for Mr. Market's mood swing back to euphoria, beyond the remarkably oversold technical and sentiment indicators going into March, appears twofold. Quantitative easing responses became more explicit across a number of central banks, and policy responses designed to avoid nationalization of U.S. banks were made public. Sightings of "green shoots," to our mind signaling little more than a less-severe pace of recession, were quickly extrapolated by many investors into expectations of an imminent economic recovery. Equity values in the U.S. banking sector doubled in a matter of weeks.

In all likelihood, Mr. Market wants his bubble back. With policymakers in WIT (whatever it takes) mode, and central banks using gasoline to put out the various credit fires, Mr. Market may believe he is going to get what he wants. Enough of panic and depression, on to manic euphoria!

Our own conclusion, as explored in prior letters, is that the old consumer credit-driven growth model is broken, and it will take some soul-searching, ingenuity and deep adjustments to find a suitable replacement. Debt-deflation dynamics may be contained and temporarily papered over by aggressive fiscal and monetary policy moves, but achieving escape velocity is another matter altogether. But what if our assessment is just plain wrong?

## **THE OTHER TAIL RISK**

We are mindful that history suggests democracies don't accept debt deflation very easily. The past century is

<b><i>THE RICHEBÄCHER LETTER</i></b>		
<b><i>In Memory of Dr. Kurt Richebächer</i></b>		
	Rob Parenteau, Editor Richard Barnard, Associate Editor	Addison Wiggin, Executive Publisher Andrew Ascosi, Graphic Designer
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littered with more hyperinflation incidents than debt deflation episodes. Inflation has tended to be the preferred method for eroding the burden of the real claims of creditors — that is, for reducing the quantity of produced goods and services that creditors can claim as debts are serviced. Following this logic, what better political cure for a world with high private debt loads and rising public debt loads than hyperinflation?

Financial engineers and professional investors have become reacquainted with the concept of “tail risk” in recent months. Tail risk is not something you run into at a singles bar late on a Friday night. Rather, it is the notion that the tails of the normal bell curve distribution are fatter than we may believe. In plain English, there is a higher frequency of extreme events than we tend to be willing to recognize. A full-blown debt deflation outcome is certainly one example of macrofinancial tail risk, and we have explored that tail risk in a previous letter discussing Irving Fisher’s 1933 contribution. At the other end of the spectrum of macrofinancial outcomes lies the tail risk of hyperinflation. In a world where professional investors are applauding massive government-funded bailouts of financial firms and other entities deemed too big to fail, we would be remiss not to investigate this opposite tail risk of hyperinflation.

### **MAKING MONEY VS. CREATING MONEY**

Milton Friedman once quipped that inflation is a monetary phenomenon, and since prices are quoted in terms of units of money, we suppose he had a point. It is a point we find about as profound as remarking that bacon is a phenomenon of animals, rather than plants, but mainstream economics is full of such insightful nostrums. Nevertheless, monetary systems are clearly relevant to pricing issues, and the monetary system we currently inhabit is not particularly well understood.

By hook or by crook, most of us have learned how to make money, as our survival depends upon it. Labor services, products and assets can be sold for money, but in order for any one of us to make money, money must first be created and somehow circulated in the economy. It is this part of the process that is usually left unexamined or poorly explained.

In the monetary system that we currently use, the nonbank private sector cannot create money. To be clear, throughout this discussion, we are referring to money as a means of final settlement. Debts and transactions can be settled with currency or checks drawn on banks accounts, but households and nonbank firms cannot print money to settle their obligations. That qualifies as counterfeiting.

There are essentially three ways money gets created in our economy. The first is the most familiar: The central bank purchases assets from the private sector and credits the bank accounts of private sellers of assets with reserves. This is an asset swap — the private sector swaps less liquid assets for newly created money.

The second is a bit less familiar. Government spending drawn on the Treasury account at the central bank also leads to the central bank crediting private bank accounts. Social Security checks do not bounce because the Fed credits bank accounts for the amount of the Treasury check.

The third was once more familiar, but has been largely forgotten. Commercial banks can create deposits by making loans or buying securities and crediting the accounts of borrowers or sellers. They need not gather deposits first. Indeed, if you stop to think about it, you will realize the money gathered as deposits has to be created at some point before it can be gathered — and again, under current monetary arrangements, the nonbank private sector cannot create money without taking the risk of being thrown in jail.

We live in what is called a fiat money system, in which money is a liability of the federal government or a commercial bank. The government maintains monopoly control over the issuance of currency. Likewise, banks, unlike money market funds, are able to create deposits by making loans or purchasing assets. Consequently, the government, as a source of money creation, has to spend before it taxes or issues bonds. The nonbank private sector can only acquire money by selling goods, services or assets to the government, or by borrowing from or selling assets to a bank.

That means in the case of countries with sovereign currencies — no fixed convertibility into other currencies or commodities like gold — and debt issued in its own currency, a government can go into default only by its own decision. The monopoly issuer of currency cannot run out of money to meet its obligations, although it can certainly wreak havoc on an economy if money creation proves excessive. Under current arrangements, for money to be created and injected into the private economy, governments must deficit spend and “underfund” the deficit (that is, government must issue fewer bonds than required to close the gap between tax revenues and expenditures — sometimes referred to as monetizing the deficit), central banks must expand their balance sheets or more private agents need to become indebted to banks or sell assets to banks.

It follows, then, that if aggressive money creation is an ingredient common to hyperinflation episodes, investors concerned about hyperinflation should keep their eyes peeled for the following combinations: Rising unfunded fiscal deficits, swelling central bank balance sheets and rapid commercial bank balance sheet expansion are all ways money creation can be turbocharged. Yet hyperinflation requires more than just money creation, and to understand this, we must now turn to the example of the Weimar Republic.

## **ROUTES TO HYPERINFLATION**

The race to zero policy rates, plus the escalation of quantitative easing, has introduced a remarkable expansion of many central bank balance sheets. This, alongside rapidly escalating fiscal deficits around the world, has provoked some professional investors to draw analogies with the Weimar Republic nearly a century ago or, more recently, Zimbabwe.

The Weimar Republic, born of a revolution in 1918, played host to a hyperinflationary breakdown of the German monetary system by 1923. Austria faced a similar episode of hyperinflation in 1921–2, and no doubt, the searing scars of these experiences deeply informed the thinking of Mises, Hayek, Haberler, Machlup and other leading contributors to the Austrian School in the 20th century.

Hyperinflation episodes are characterized by rapidly accelerating inflation, a collapsing foreign exchange rate and, eventually, a widespread disorientation and disruption of productive activity. Keynes, writing in 1919, well before the terminal stages of the Weimar hyperinflation had been revealed, characterized the nature of the mayhem involved in such episodes as follows:

*As the inflation proceeds, and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.*

While many theories abound, the source of hyperinflation appears to be twofold. Frequently, an ever-escalating creation of money is associated with a hyperinflation episode. As mentioned above, central banks can create money out of thin air by crediting the bank accounts of those receiving government expenditures or tax breaks. Central banks may also accept commercial bills — what we would today essentially recognize as working capital loans — as collateral from businesses in return for crediting their bank accounts. Alternatively, financial innovation may allow banks to find ways of expanding their balance sheets — say, through mechanisms like sweep accounts — thereby leading to an acceleration of the money supply as the innovation is adopted more widely. This first element of a hyperinflationary episode, in other words, works on the size of the outstanding money stock.

A loss of confidence in a currency as a store of value can also prompt hyperinflation, independent of any change in the stock of money outstanding. This route to hyperinflation is very reminiscent of a bank run, and it can happen when a nation appears to be losing a war, a government appears on the verge of collapse or as inflation is heating up beyond historical norms in an economy. Wage earners, for example, fearing their money incomes will command fewer goods and services in the future, will spend more of their income and hoard durable goods in an attempt to preserve some degree of their purchasing power. This second element works on the velocity of circulation of the money stock, or the speed with which money changes hands in the economy. In his 1936 essay, Mises put this

dynamic as follows:

*As soon as public opinion becomes aware that there is no reason to expect an end to inflation, and that prices will continue to rise, panic sets in. No one wants to keep his money, because its possession implies greater and greater losses from one day to the next; everyone rushes to exchange money for goods, people buy things they have no considerable use for without even considering the price, just in order to get rid of the money. Such is the phenomenon that occurred in Germany... known as 'the flight into real values.'*

When the future purchasing power of a currency appears seriously in question, holders of a currency will try to spend money on tangible assets or produced goods and services today, rather than tomorrow. Similarly, holders of financial assets in that currency will also attempt to shift their portfolios in favor of tangible assets, or they will attempt to exchange their current holdings for assets denominated in foreign currencies.

The feedback effects from these shifts in spending propensities and portfolio preferences are the means by which the vicious cycle of hyperinflation gets unleashed. Higher private spending out of income flows will tend to feed final product price inflation. Portfolio shifts into tangible assets will tend to raise the price of agricultural land, real estate, precious and industrial metals and other inputs to production, creating adverse shifts in cost conditions. Creditors, realizing they are getting paid back principal in a currency with less purchasing power, will demand higher interest rates, thereby increasing costs for capital-intensive or long-duration production, as well as for housing, or they will withdraw long-term credit altogether. In addition, currency depreciation arising with the flight to foreign currencies leads to higher import prices, which can raise the prices of both imported final goods and imported inputs to production.

In this fashion, increased money claims on real output or existing tangible assets lead to additional distributional conflict, and it is this unresolved conflict we believe lies at the heart of the inflationary spiral. For example, when the foreign exchange value of a currency falls, the real cost of servicing foreign debt obligations also rises, as more production must be sold abroad in order to earn the same amount of foreign exchange. Production diverted abroad is not available to meet domestic demands. Should the fiscal deficit be increasing at the same time, more domestic output is claimed by the government. While goods and services are diverted abroad or to the public sector, the private sector is trying to run down its cash balances, reduce its saving rate and claim more output with its money. In market economies, the inevitable outcome of too many distributional claims being applied on the available supply of output can only be one thing: higher prices.

On the surface, then, hyperinflation appears tied to either aggressive money creation or an acceleration in the rate of circulation of money through the economy. Beneath the surface lies an unresolved conflict between different agents in the economy over real claims on goods, services and tangible assets. While it is often said in the trading pits that the cure for higher prices is higher prices — meaning higher prices will clear markets by restricting demand and encouraging supply — the combination of unresolved distributional conflicts and a flexible monetary system can lead to a violation of this basic microeconomic principle.

The terminal stages of hyperinflation also tend to be associated with a breakdown of production. Industrialists will often find it more profitable to speculate in commodities or foreign currencies than to keep manufacturing plants operating. Banks will either refuse to make working capital loans to firms, or they will only do so at prohibitively high interest rates. Supply becomes credit constrained in both manufacturing and agriculture, where production takes time. Households on fixed nominal incomes, as well as workers without unions or without bargaining power, find wages trailing consumer price inflation, and they must adapt with a lower material standard of living, thereby lowering unit volume demand. All of these responses during the terminal stage of hyperinflation discourage production, so they can lead to a breakdown of the economic foundation of a nation.

One insightful account of the nature of the production breakdown can be found in the following description of the final chapters of the Weimar hyperinflation:

*By mid-1923 workers were being paid as often as three times a day. Their wives would meet them,*

*take the money and rush to the shops to exchange it for goods. However, by this time, more and more often, shops were empty. Storekeepers could not obtain goods or could not do business fast enough to protect their cash receipts. Farmers refused to bring produce into the city in return for worthless paper. Food riots broke out. Parties of workers marched into the countryside to dig up vegetables and to loot the farms. Businesses started to close down and unemployment suddenly soared. The economy was collapsing.*

As a result, the resolution of a hyperinflation episode usually requires shock therapy. As a psychological trick, zeroes are lopped off of notes and bills as the old currency form is often redenominated or revalued in favor of a new currency. Money creation is often restricted by the adoption of a fixed exchange rate regime, a precious metal convertibility feature that replaces fiat or credit money with commodity money or a currency board (in which a nation must earn foreign exchange by running a trade surplus before it can create its own money). The financial system is rebooted, but this time, money and credit growth are tightly constrained. Consequently, all the economic activity that seemed justified and profitable under a hyperinflation regime is revealed as an illusion and a gross misdirection of productive resources. Hyperinflation, in other words, invokes the ultimate Austrian School nightmare of squandered savings and misdirected entrepreneurial activity.

Once a nation concludes it has no choice but to revamp a hyperinflationary monetary system, economic activity often plunges further into a cold bath, as all the resource misallocation that developed during the hyperinflation must be sorted out. For example, during a hyperinflation episode, one of the most lucrative portfolio positions is to borrow at a fixed nominal interest rate — preferably early in the hyperinflation episode, and with a long maturity loan — and use the proceeds to fund long positions in tangible assets, like land, real estate, gold or inventories of durable goods. Price signals are bound to divert resources into the production of such inflation hedges. The derangement and distortion of the economy's productive capacity under hyperinflation must be unwound, rearranged and, in some cases, simply written off once the shock therapy takes effect.

## **WEIMAR 2.0?**

Needless to say, hyperinflation is not something most of us would care to experience in our lifetimes. Suggestions that we are headed toward hyperinflation should neither be offered nor accepted lightly. Are there enough parallels with the Weimar experience to validate current hyperinflation concerns? Volumes have been written on the Weimar experience, and much remains disputed, so we will highlight some of the key elements required to make an initial assessment.

First off, it is important to remember that German production capacity was either significantly damaged by World War I or redirected toward output required by the military. The Allied blockade further restricted imports well into 1919, and in 1923, French and Belgian troops occupied the Ruhr Valley, which held a good deal of Germany's manufacturing base. All of these measures significantly restricted Germany's capacity to produce, fueling the distributional conflict that fed the hyperinflation.

This time around, the real net capital stock growth in the United States has been slow, on the order of 1–2% per year, and the manufacturing sector is currently operating with one-third of its capacity idled. Plant, equipment and labor have not been physically destroyed — rather, reinvestment rates have remained low. While trade has been inhibited by credit disruptions and some protectionist responses, import prices are falling as export-driven economies struggle to reverse declining shipments.

Second, Weimar Germany faced large foreign claims from war reparations, as well as exploding budget deficits. By 1919, it is reported the German budget deficit was equal to half of GDP, and by 1921, war reparation payments represented one-third of government spending. Projected fiscal deficits are as high as 12–13% for the United States and the United Kingdom in 2009, so the scale of the fiscal responses, though large, is not nearly as large as those undertaken by the Social Democratic Party as it attempted to quell social unrest following the Revolution of 1918 with a variety of social benefit programs.

In the United States, while foreign investors do hold large Treasury bond positions, the debt service paid by the U.S. government to foreign holders amounted to \$167 billion in 2008. While this is up from \$82 billion in 2004, interest payments on foreign-held Treasury debt are not ballooning the U.S. budget deficit on a scale similar to the Weimar experience. An interest rate spike could change that, but the current foreign interest payment burden is clearly not a third of the budget deficit, as it was during the Weimar experience.

In addition, the United States is still running a trade deficit on the order of \$338 billion in Q1, making the type of distributional conflict over real output that lies behind hyperinflation episodes harder to accomplish. More goods and services are coming into the United States than going out. This too could change if foreign net saving preferences fall and the United States has to run a trade surplus.

Third, German trade union membership quadrupled from 1914–1920, and the 1918 revolution ushered in a government led by a Social Democratic Party that instituted an eight-hour work day and provided social benefits in order to reduce social unrest. Many unions were able to negotiate cost-of-living adjustments in their wage packages after the mark fell in 1921, creating an automatic feedback mechanism from price inflation to wage hikes. Absent such mechanisms, nominal wage and salary growth cannot keep up with rising consumer prices. Real wages fall; household purchasing power is undermined; and the volume of output households can claim diminishes, unless consumer credit facilities can fill the gap.

The new U.S. administration does display a social democratic rhetoric, but so far, redistributive policies have primarily benefited financial institutions. Social benefit payments are up 12% versus a year ago on a spike in unemployment benefits, and public health care insurance proposals are on the table. However, trade unions outside the public sector have withered, and cost-of-living adjustment clauses have largely disappeared since the early '80s (although some government benefits like Social Security retain them). Average hourly earnings are up only 1.8% annualized over the three months ending in April, and we would not be surprised to see wage deflation before the unemployment rate peaks this time. U.S. households are net paying down debt — even credit card debt — and creditors remain reluctant to make new loans, so the odds of a wage/price spiral taking root look decidedly low.

Undoubtedly, the Reichsbank had a hand in the Weimar hyperinflation, having become accustomed to “monetizing” German government debt during World War I after gold convertibility was severed. However, while price levels quintupled between the armistice and February 1920, currency in circulation only doubled, leading many politicians to blithely claim monetary policy could not be blamed for inflation. An increase in money velocity must have played a role, although the monetary arrangements of the Reichsbank became increasingly suspect.

The Reichsbank had pegged the discount rate at 5% and accepted private commercial debt for discounting under what was known as the Real Bills doctrine of the time. Money creation to finance production was not believed to carry an inflationary impulse, as both money and produced goods were increasing in concert. Direct loans to businesses were ramped up by the central bank after December 1921, when private financial institutions began to withhold credit as inflation accelerated. The assassination of Foreign Minister Rathenau in 1922 set off a selling spree of German bonds by foreign investors, and the central bank was once again forced to offset the run with more purchases of German government obligations.

Central bank mayhem aside, the culminating chapter of the Weimar hyperinflation does appear closely related to the response to reparation demands. The May 1921 so-called London ultimatum required annual installment payments of \$2 billion in gold or foreign currency, in addition to a claim on just over a quarter of the value of German exports. Germany attempted to accumulate foreign exchange by paying with Treasury bills and commercial debts denominated in marks, but the mark simply went into free fall on foreign exchange markets as this ploy fell flat. The January 1923 occupation of the Ruhr by Belgian and French troops seeking to secure reparation payments in goods — since the mark was nearly worthless — was the final straw. German production was lost as workers employed a passive-resistance response, and money was printed by the Weimar government to continue to pay workers despite their production halt. Within months, the German monetary system collapsed.

Today, there can be no question broad money growth has surged in many countries around the world. Through

March end, U.K. M4 was up 18% against a year ago, China's M2 was up 26%, Switzerland's M2 was up 30%, Canada's M2 was up 14% and U.S. M2 was up 9%. There can also be no question that budget deficits as a share of GDP have equally surged. Behind the U.S.' and U.K.'s 12–13% budget shares, Spain is due in at nearly 10%, Russia at 8%, Japan nearly 6% and the euro area nearly 5.5%. Even German Chancellor Angela Merkel, following the sharpest quarterly decline in German growth since 1970, has initiated a \$111 billion fiscal stimulus package. In addition, the European Central Bank has moved to a 1% policy rate, with \$81 billion of covered bond purchases scheduled for their opening move to quantitative easing.

Against the explosion of money stock measures and fiscal deficits — of which Weimar must be viewed as a supersized version — remains a deceleration in private credit growth, an impairment of financial institutions, a rebuilding of cash reserves and a collapse of private spending. While the Fed's balance sheet is still nearly 2½ times the size it was a year ago, it has shrunk by \$102 billion since the end of 2008. Total assets held by U.S. commercial banks have also shrunk by \$50 billion through mid-May. Commercial banks are still sitting on \$1 trillion in cash reserves, just as they were at the turn of the year. They have been unwilling to lend those reserves or invest them in securities like Treasuries. No doubt, banks are bracing for further loan losses from credit cards, commercial real estate and the continuing home price deflation.

Strictly speaking, the Austrian School defines inflation as money creation not backed by real saving (that is, available durable goods, like gold). Price inflation is merely the symptom of such money creation. However, as a practical matter, if money is hoarded in a precautionary fashion, and not spent on goods and services, price inflation is thwarted. Mises, writing in 1936, was able to recognize this practical consideration:

*Once the reversal of the trade cycle sets in following the change in banking policy, it becomes very difficult to obtain loans, because of the general restriction of credit... It is a well-known phenomenon, indeed, that in a period of depressions, a very low rate of interest... does not succeed in stimulating economic activity. The cash reserves of individual and of banks grow, liquid funds accumulate, yet the depression continues... capitalists prefer to hold their funds in a form that permits them, in such a case, to protect their money from losses inherent in an eventual devaluation... capitalists today are reluctant to tie themselves, through permanent investments, to a particular currency. This is why they allow their bank accounts to grow even though they return only very little interest, and hoard gold, which not only pays no interest, but also involves storage expenses.*

Mises is describing a situation similar to what we see today. Banks, households and companies are holding onto cash as uncertainty is rife. Job destruction prevails, profit contraction continues and private credit is scarce. Cash cushions are built up on household, business and bank portfolios despite minimal short-term yields to weather the storm. In a hyperinflation like that experienced during the Weimar Republic, no one wants to hold cash — cash is a hot potato, a wasting asset.

In fact, we believe the surge in money creation and fiscal deficits pursued by governments around the world are running headlong into debt deflation dynamics — dynamics that we believe were unleashed by the derailment of a global economy built on unsustainable credit flows. Imagine two tidal waves colliding in midocean. So far, the policy response appears to be containing debt deflation risks, as manufacturing purchasing manager surveys from around the world have begun to show less-severe recession readings in recent months, and even as some housing-related series have begun to stabilize globally. Aggressive policy responses may lead more households and firms to question the nature of fiat money, but so far, private spending around the world remains in retreat, or at best, as with the case of U.S. retail sales, relatively flat year to date.

The “flight into real values” associated with hyperinflations, while evident on the margins with rising commodity prices, is being swamped by the contraction of private spending. Falling nominal GDP is the result in many countries around the world. In addition, while global investor risk appetites have increased in the past three months, a high level of liquidity preference is still evident in private portfolios despite low yields on near-cash instruments. Should inflation start to accelerate — and after all, from this point in time, that is what central banks pursuing “price stability” targets are required to achieve — we believe labor has neither the bargaining power nor the access to credit

to keep up with rising prices. Household claims on real resources would wither under inflation as real wages would simply fall behind. To our minds, the distributional conflict lying underneath hyperinflation episodes could not be sustained, at least on this front.

Nevertheless, we cannot ignore the increasingly vocal complaints regarding the U.S. abuse of its privileges as the provider of the global reserve currency. Threats of foreign portfolio diversification away from dollar-denominated assets have become more credible as China has increased positions in commodities and the Gulf states explore launching their own common currency. We also cannot ignore the possibility that the mountain of government bond issuance around the world will prove difficult to place in private portfolios, and central bank accumulation will be forced to accelerate to prevent any spike in Treasury yields that would surely threaten any incipient economic recovery. Indeed, some professional investors may believe they have found another Soros 1992 trade. They believe if central banks are forced to buy government debt in size, the “flight into real values,” namely, durable assets viewed as inflation hedges, will escalate accordingly. Instead of breaking the Bank of England, the notion is to break the back of fiat currencies.

We conclude we are far enough into uncharted waters that we can justify hedging portfolios against this second tail risk of hyperinflation. Too many people want their bubble back, and the politicians are listening and doing their best to provide it. Precious metals are one obvious hedge to increasing concerns about the future of fiat currencies, and we have used the exchange-traded funds (ETFs) on gold and silver to place this hedge. We are also finding short dollar positions against so-called commodity currencies like the Australian dollar, the Norwegian krone and the Canadian dollar are starting to prove profitable as the United States is viewed as the most aggressive in executing quantitative easing. EverBank also provides a variety of CD and money market accounts denominated in foreign currencies that may offer another way to preserve the purchasing power of relatively liquid funds.

We have considered energy and material exposures in equity markets outside the United States as a double-barreled currency and commodity play, but have not been willing to pull the trigger, given the severe global recession that still prevails and we believe will prove difficult to escape. Similarly, the agricultural land plays that Bill Bonner at *The Daily Reckoning* and Chris Mayer at *Capital & Crisis* have kindly identified are another idea we are investigating. Clearly, owning agricultural land with fixed-rate, long-dated debt was one strategy that worked during hyperinflation. Nevertheless, these are options we will begin deploying if the weight of evidence points to a rising risk of a hyperinflation outcome.

## **MR. MARKET, MEET STRUCTURAL UNEMPLOYMENT**

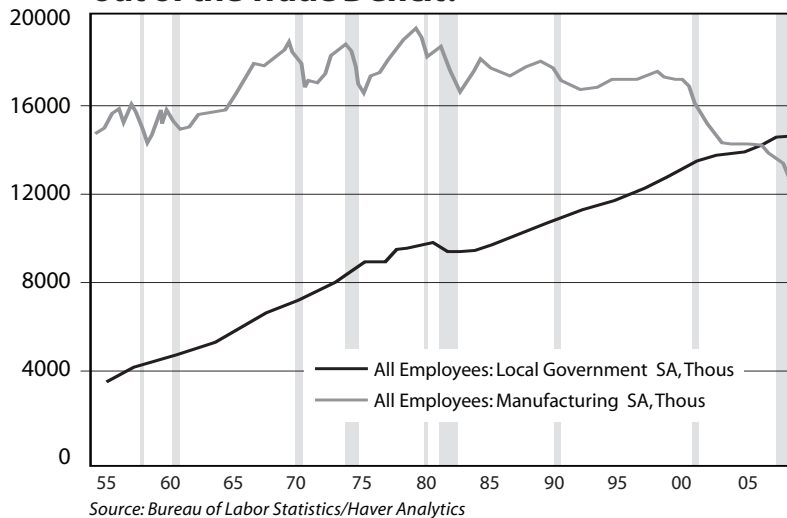
When a credit bubble bursts, Austrian theory suggests structural dislocations will be revealed horizontally, across the mix of consumer products and services, and vertically, back through the value-added chain to capital goods and raw materials production. Barring the inflation of a new asset bubble, these labor, capital and material resources must be released, repriced, reconfigured and reabsorbed in new production areas.

From the December 2007 peak to the April 2009 results, payroll employment has contracted by 5.6 million workers. In addition, the household employment survey finds 5.9 million people want a job but have left the labor force out of discouragement. After-tax personal income per capita in the United States was estimated at \$35,170 in Q1 2009. Putting this together with 11.5 million idled workers, we can conclude \$404 billion in potential income is not being produced. No small part of this unrecoverable waste of resources is due to the reversal of the last credit bubble.

When we drill down through the payroll losses to identify the sectors taking the largest hits, this point becomes immediately apparent. Nearly 1.2 million jobs have been lost in the construction sector, with another 428,000 shed in finance, insurance and real estate. These are the direct hits of the burst housing bubble, as well as indirect hits on those who created and sold structured-finance instruments built off of mortgage debt. Another 1.2 million jobs have been lost in durable manufacturing, with 754,000 shed in retail and 401,000 shed in leisure and hospitality. These are the indirect hits linked to household deficit spending on the back of the house price bubble.

On average, idled U.S. workers are currently spending nearly 24 weeks — nearly half a year — before finding new work, exceeding the nearly 22 weeks in May 1983 that previously marked the post-World War II high. The 1980–82 recession was understood as a structural dislocation, and policies to accomplish reindustrialization were under heated debate. By 2006, the peak of the housing bubble, the number of workers employed in the manufacturing sector had fallen below the number employed by local government. In retrospect, reindustrialization succumbed to globalization and financialization of the U.S. economy. While we recognize U.S. manufacturing labor productivity improved over the decades, we doubt the United States can export its way out its trade deficit with more people employed in producing local government services than in tradable goods production.

### How, Then, Does the U.S. Export Its Way out of the Trade Deficit?



Too many productive resources were tied up in bubble-driven activities. Many of these jobs will not be coming back. Policy stimulus can paper over this in the short run, but the green shoots crowd needs to acknowledge that structural challenges lie ahead, and they are unlikely to be worked out overnight.

## ON MACRO AND INVESTING

As Agora Financial launches the Richebächer Society, we look forward to enriching and widening the dialogue with readers of *The Richebächer Letter*. We hope to have features on the new Richebächer Web site that will allow a deeper conversation to develop across the readership, and we also look forward to meeting some of you in person in Vancouver this July. In the meantime, as always, feel free to write or e-mail Agora with your questions, comments and insights.

To that end, now that we are nearly a year into my stewardship of the *Richebächer Letter*, we found the following question from one reader especially appropriate: “What is the purpose of *The Richebächer Letter*? Is it an attempt to teach university-level economics to the masses, or is it supposed to assist investors to make money?”

Frankly, like Dr. Richebächer, we find most contemporary university-level economics has become less and less relevant to the world we inhabit. As we have highlighted in prior letters, mainstream economics has gone wandering down some fairly blind alleys over the past few decades. Dr. Richebächer frequently exposed the various hidden assumptions, convoluted lines of argument and outright missteps made by Wall Street economists, policymakers and the financial press on the basis of mainstream macroeconomics. As J.M. Keynes wrote a lifetime ago in *The General Theory*, “It may well be that the classical theory represents the way in which we should like our Economy to behave. But to assume that it actually does so is to assume our difficulties away.” Less diplomatic conclusions about the relevance of mainstream economics can also be found liberally sprinkled throughout the work of Mises and other Austrian School adherents.

To the beef shared by Dr. Richebächer, Keynes and Mises, we must add two additional concerns. Technology has flooded traders and investors with volumes of instantaneous data. Economic results are immediately available to everyone, quickly compared against consensus expectations and then rapidly devoured like fast food. Positions are reviewed, trades are submitted and then it is on to the next incoming news flash. Myopia and short-term trend-following behavior reign in financial markets.

Beyond that, thousands of blogs have sprouted up on the Internet. With the exception of a few gems, many of them are offering various predigested, half-baked and sometimes utterly misguided interpretations of financial and economic developments. The volume of misinformation and misinterpretation dwarfs that which frustrated Dr. Richebächer during his career of cutting through the Wall Street and financial press fog — and these days, Wall Street is recognized as either unworthy of trust or a victim of a brain drain into hedge funds, while previously prominent newspapers are folding left and right.

Our experience has been that if you don't have a map, you are bound to get led around by the nose, and Mr. Market will eventually pick your pocket clean if that is the case. Eventually, you are likely to get quite lost, or even forget your destination. Dr. Richebächer's point was to always seek out a better map, and to use that map to gain an investing advantage. To find a better map, Dr. Richebächer had to reach back to some of the more original thinkers in macroeconomics and finance and reconstruct a sensible conceptual framework from the clues he was able to recover and apply to contemporary situations. Our purpose is to make that map clear and available to our readers, to continuously update and apply that map to current and anticipated developments. The point is to identify risks and opportunities in financial markets based on an ever-evolving macro map, but one with some very clear compass points.

If the model of the economic world we have adopted from Dr. Richebächer suggests rising odds of a recession, as it did during the beginning of the summer, we reduce the risk profile in our portfolio by moving into bonds and cash while reducing equity and less-liquid asset class exposures. If our analysis suggests debt deflation risks are introduced by the onset of a recession, as it did as the summer progressed, then we make it clear that remaining equity holdings are best shifted to sectors in which companies tend to have less balance sheet leverage and less cyclical earnings growth, and we look to capitalize on falling yields for Treasury bonds.

If we find flaws in the policy response to debt-deflation risks, as we have with our analysis of the quantitative easing approach, we identify which asset classes may be most vulnerable. In the case of quantitative easing, we now see real challenges to the government in finding private buyers for Treasury bonds, and we believe yields are just beginning to reflect this.

If our analysis leads us to conclude the prior consumer debt-driven growth model is unlikely to be easily revived, as it did back in the fall, we are straightaway led to question equity values in the export nations. Until the Asian export nations are able to generate their own domestic demand, they are likely to face challenges posed by excess capacity. Currency repercussions are also implied by the disruption of the old global growth model. Japan, which just printed a 15.2% real GDP decline in Q1 2009, may need to follow Korea in depreciating its currency in order to make its exports cheaper. Our analysis suggests we need to search for new growth models to replace the imperiled, if not obsolete, consumer debt-driven model. While others offer a counsel of despondency and despair, we look toward new technologies that can be ramped up, energy independence plays and the upgrading of public infrastructure investment as possible paths forward.

Investing icons like Peter Lynch, Bill Miller and Warren Buffett have been emulated throughout the professional portfolio management world. Each of these icons describes himself first and foremost as a bottom-up stock picker. Macro is of little or no concern to them: Their careers have been built on finding the best management in the best lines of business at the best price. In fact, Peter Lynch once quipped if you spend more than one day of the year thinking about macro influences on investments, you have spent too much time already.

With all due respect to the investing accomplishments of these luminaries, a blind spot on macro conditions is liable to leave portfolios blindsided at some point along the way. Bill Miller's fund, Legg Mason Value Trust, is a case in point. After a 15-year streak of beating the S&P 500 — a feat deemed nearly impossible under efficient-market theory — Miller got tripped up in 2006.

2006 just happened to be when the housing boom peaked. Miller runs a concentrated portfolio with few equity positions, and certainly no one can fault him for having the courage of his convictions. Along the way, bottom-up analysis led Bill Miller to hold Bear Stearns, AIG and Freddie Mac, all three of which have subsequently found

themselves at ground zero of the recent financial crisis. Needless to say, Legg Mason Value Trust clients have suffered a rough three years, with Miller's fund reportedly trailing 99% of equity mutual funds over that period. Miller continues to believe financial stocks will be one of the best investments for the next decade. A free subscription to *The Richebächer Letter* may be just what the good doctor ordered.

No doubt, by early March, more than a handful of financial firms had been crushed by investor fears of imminent nationalization or outright failure. But we remain hard-pressed to identify a robust business model for banks and their brethren. Our analysis suggests the private sector is likely to continue to deleverage while the public sector releverages. That means loan volumes and new corporate or mortgage bond issuance are likely to be muted relative to history. Banks will be left riding the steep yield curve by accumulating Treasuries with lower-cost funds. However, they are not even doing that at the moment, as cash reserves are being hoarded, rather than deployed into Treasury bonds. Refinancing fees and accounting shenanigans may hold bank earnings up as the private sector tries to reduce its debt service burden, but these fee streams are likely to be offset by rising losses on residential real estate, credit card and commercial real estate loans. In addition, refinancing, by definition, lowers the level of the interest payments banks will be receiving in future quarters.

The Kabuki theater of the bank stress tests did (surprise, surprise) provide the required results, and banks are successfully raising capital while paying back Troubled Asset Relief Program injections. Existing shareholders are getting diluted by new equity issuance — although if banks are running losses, maybe dilution is to be preferred. There will, of course, always be some form of a banking system, but we will be shocked if that form is not more heavily regulated than it has been for much of the past three decades. At a minimum, investors in banks are facing unusual uncertainty about the future returns on equity and the long-run earnings growth that can be accomplished in such an environment.

We admire Bill Miller's achievements, and we sincerely hope he is able to complete his career on a high note. However, there is clearly a price to be paid by ignoring macro dynamics, especially those related to credit distortions. Even investors who find stock selection is their strong suit need to keep one eye open for the risks and opportunities that can be identified with the type of sensible macro analysis that Dr. Richebächer provided over his long career.

ETFs may be used to pursue the themes we have offered in the past year of letters, but we should also remind you that Agora's comprehensive stable of newsletters and alerts may come in very handy in mapping our macro themes to specific investment ideas. Bill Jenkins provides pointed currency option trades in *Master FX Options Trader*. Patrick Cox introduces promising new technologies that may play a critical role in rebuilding global growth prospects in his publication *Breakthrough Technology Alert*. Chris Mayer identifies ways to play key themes, like water infrastructure in *Capital & Crisis*. While each of these investors is an independent thinker in his own right, you may often find the ideas we are developing in *The Richebächer Letter* overlap with the opportunities uncovered in these and other Agora publications.

Dusting off and extending Dr. Richebächer's map is, to our mind, not just an intellectual exercise. Our sincere apologies if our efforts at cartography have felt like university lectures to some, but we have always subscribed to the "teach a man to fish, rather than hand him a fish" approach. Our intention is to render Dr. Richebächer's unique approaches as transparently available to readers as we can. After all, at the end of the day, you need to be able to weigh the arguments and make up your own mind if you are going to successfully pick the pocket of Mr. Market. Because these approaches are often at odds with conventional wisdom, we feel compelled to spell them out. But precisely because they are unconventional macro views, we believe they can be used to make money in financial markets — and certainly, that was the experience of Dr. Richebächer.