Illusions & Distortions In Our Economy

Sentiment is euphoric – Is it accounting for all the risks?

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Introduction

Much of what we see in the economy and markets is an illusion. Our prosperity in this country is also a bit of an illusion, in a sense. That's not to say that we're not a prosperous nation – we are. But that prosperity in many ways is grounded in ether. And that's true of just about every western and developed economy on earth. So, in a relative sense, we're still the most prosperous nation on earth, but it's *not as secure* as many would have you believe.

The purpose of this report is to point out the illusions and distortions in our economy. It's also to point out that risk-taking is necessary, of course, but it seems some are over-doing it based on illusions. In that vein, this report is a call to sanity. Excessive risk-taking is never a good idea, but after putting the illusions in focus, it seems an extraordinarily bad idea.

Business Cycle

We start with the notion of a business cycle. Everyone old enough to have been working in 2000 has lived through two recessions. Some of us even remember the mild recession of 1991 and the double-dips in 1980 and 1981. We, therefore, are fully aware that booms and busts can and do occur. But why?

Money. The reason we have booms and busts is because we periodically create too much money. No nation on earth currently ties their currency to a hard commodity like gold. Therefore, there is no constraint on how much money can be created. Money is created by your local bank when you take out a loan. If the bank approves you for a loan for, say, $10,000, after a day or two, $10,000 magically appears in your checking account. Did this money come from other depositors at the bank? Probably not. In fact, the bank only has 10% of its clients' deposits on hand or easily accessible. If one day, everyone in the country woke up and tried to withdraw all of their money, there would be quite a shock – banks don't have it all on hand.

Banks create loan deposits out of thin air. It's an accounting line item for them and with a few keystrokes, voila, money has been created. The money supply, the day you received your loan proceeds, went up by $10,000.

The effect of this fractional reserve system is that it drives down interest rates below the rate that would hold had the new money not been created. If the supply of money increases, while demand remains unchanged, the price of money must go down. And the price of money is the interest rate. It's simple supply and demand.

When the nominal rate of interest (the rate in the money market currently) is driven below the natural rate of interest (what people would agree to with a constant money supply), crazy things start taking place in the economy and in society, more broadly. The most important of these crazy things is malinvestment.

Notice, we said "*mal-*" investment – not *under*-investment and not *over*-investment. And investment here is used in the economic sense of the term. That means investing in property, plant, equipment and people. It does not refer to investing in stocks or bonds. Malinvestment is analogous to malnourishment. The patient is getting food and nourishment, yes, but not the right kind. She is not over- or under-eating.

The same is true with malinvestment. Companies are investing in themselves through additions to property, plant equipment and people, yes, but not the right kinds of investments and not in the right sectors of the economy. Therefore, they are not sustainable.

Suppose interest rates would normally be 10% for a 10-year $10 million loan to a credit-worthy corporate borrower, assuming a constant supply of money. The borrower will only engage in expansion of her business if she calculates that she can make more than 10% per year on the $10 million.

We don't have a constant supply of money, though. We have an ever-growing supply of money because banks can and do create it out of thin air, and since they earn interest on loans, they are very highly incentivized to do just that. When money supply increases, the interest rate falls below the 10% it would be at naturally.

Let's say the interest rate dropped to 3% in the market but that 10% is still the natural rate a lender and borrower would agree to under a constant money supply. Now the business owner can borrow $10 million and only have to generate greater than 3% returns. So, that's what she does. She invests in a $10 million project expected to yield about 4% or 5% per year.

Eventually, though, all of similar spending nationwide creates inflation and interest rates start to rise, with or without the Fed hiking them. And as rates approach the natural rate of 10%, the bust sets in. Projects that were only earning 4% must be liquidated and we call that the "bust," or "recession."

Had the nominal rate not ever dropped from the natural rate, that project yielding only 4% would have never even been started in the first place. In fact, perhaps no project would have been added at all if it had to earn over 10% to be profitable. So, there would not have been a liquidation, and there wouldn't have been a bust.

The final point here is this. When banks are creating money out of thin air, the economy seems to enjoy general prosperity. It's a "boom." But without money-printing, the boom would not occur. The boom is the artificial part of the cycle. The bust tries to get things back to normal and is therefore not the problem. Rather, the bust is the cure.

It's about time we all admitted that the booms are abnormal and need to be fixed. The busts are normal and should not be interfered with. It's the boom that creates illusion of prosperity and malinvestment and it's the boom that's most dangerous. Would anyone dare call a diet "harmful" to someone who overeats, while thinking the eating habits that led to the obesity in the first place "normal"? Well, that's how your government and its agencies view boom/bust cycles – there's no problem with overeating, but if the doctor says to go on a diet, there's no end to the mischief concocted in Washington, D.C., supposedly to save us from the evils of dieting. "Bring on the fast food," they'll yell. And special interests will gather in the nation's capital to figure out new and better ideas for diet-avoidance and a continuation of overindulgence. And, of course, there will be politicians and special interest groups determining how much money they can make off of the process of re-fattening America.

GDP

What most people refer to when talking about the health of our economy is Gross Domestic Product (GDP). Rarely do the people talking about GDP know how its calculated, and fewer still know that it's mainly rubbish, and one of the greater illusions. This illusion is right out of the magician's handbook.

GDP purportedly measures national income. It's calculated as such:

GDP = Consumption Spending + Private Investment + Government Spending + Exports – Imports.

Or, algebraically, it's GDP = C + I + G + (X – M). Now, something should strike you as strange about this calculation. If government spending is a part of the mix, can't we always have a great GDP? Can't government always and everywhere spend what it wants? Isn't the government unconstrained in its budget? Can't the government just create money out of thin air? The answer is "yes" to all of those questions. In fact, socialist countries can and do inflate the government spending number in their GDP numbers for the exact reason that they wish to show high GDP numbers.

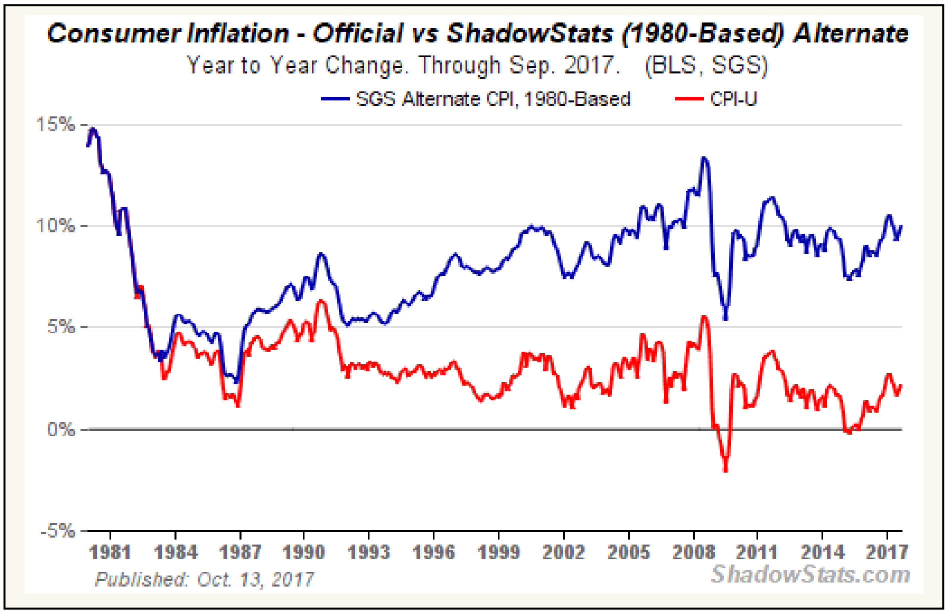
But in the relatively free developed economies, governments won't inflate "G" with no constraint, as it would cause inflation. But they can inflate that number. The issue for us is whether or not debt is income. Let's think about that a little.

Is debt income? Let's say you go to the bank to take out a loan for a car. Let's specifically assume you get a 5-year, $20,000 loan to buy the car that you want. One week after getting the loan and buying your new car, you have an increase in your assets of the value of the new car but you also have a new debt of $20,000, so your net worth did not change. We all understand that. Less understood is the loan proceeds. The bank gave you the $20,000. Will you report that as income? No? Why not? You won't because you know that loan proceeds are not income. It was not earned. You will pay it back to the bank. If it's income, it's unencumbered by a debt obligation. The same holds for your house. When you got your mortgage, did you claim the loan proceeds as income? No. Why? It's not income – it's debt. So, can we agree that debt is not income? We hope so, but government statisticians do not believe this.

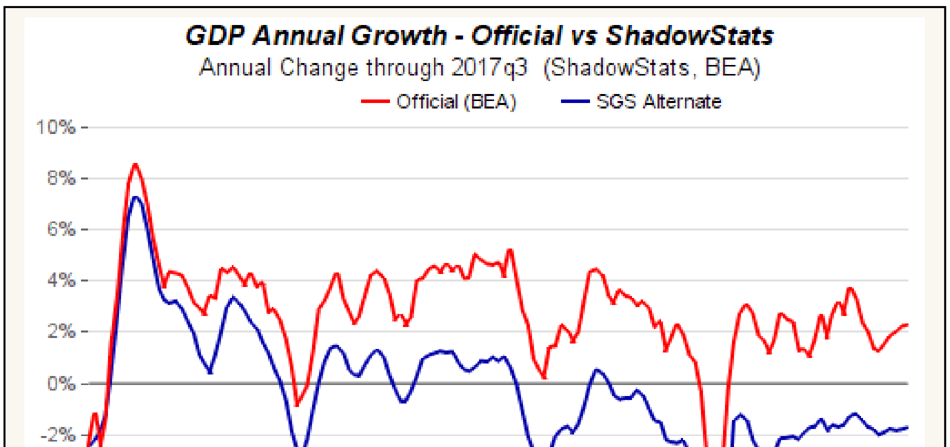
Back to GDP. Government spending (G) can come from tax revenues and that is the government's only source of income. Or, they can spend loan proceeds. The Treasury issues bonds which are government debt. When the bondholder (lender) gets her money back, it will come from the government (borrower). So, the government has two sources of funds it can spend – income (through taxes) or loan proceeds (from the issuance of bonds). If we're counting the spending of loan proceeds as income for the government, we are making an error.

So, the first step in ridding ourselves of this logical error is to know what "real" GDP is, so that we can then strip out loan proceeds from the total. That's because loan proceeds are not income and the whole idea with GDP is to measure national income. And we need to strip out inflation to get a "real" GDP number, otherwise an increase GDP may just be due to a general increase in prices and not an increase in income.

"Real" GDP is the national income (GDP) less the rate of inflation. But the rate of inflation has been tampered with twice over the last 40 years, in each case to show a lower rate of inflation than would have otherwise been the case. Those of us more cynical types might suggest this was done to keep the cost-of- living adjustments to social security benefits artificially low. Our current inflation rate is another illusion. Thankfully, John Williams at Shadow States has been applying the same methodology to calculating today's inflation rate that was used before the two recent changes. The difference is interesting to say the least. If we were using the same method as prior to 1980, inflation would be reported at 10% currently, not the roughly 2% number the mainstream media dutifully reports.

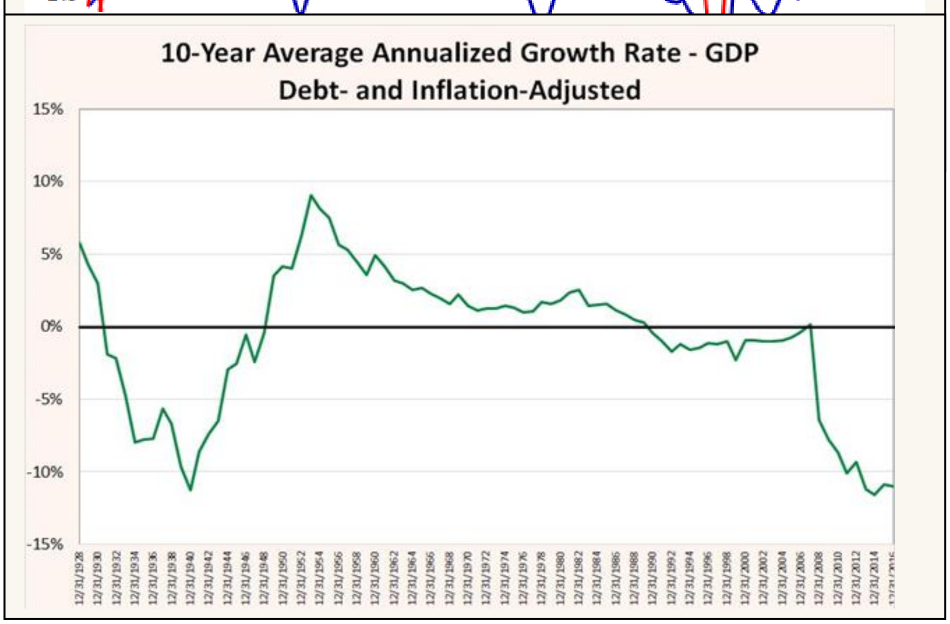


And since "real" GDP is GDP net of inflation, GDP has been artificially high. We need to subtract the more realistic inflation number from GDP to get a more realistic "real" GDP number and from there, we can deduct the spending of loan proceeds.



The blue line is a more accurate depiction of where "real" GDP is. Shockingly, it's been mainly negative since the tech-bust recession of 2000. The red line is the illusion.

Now we are in a position to strip out the government's spending of loan proceeds, because debt is not income. The results are also a bit shocking. It currently looks more like we're in a depression than an expansion. This has very little to do with Donald Trump. It's got a little to do with former president Obama. But it's got a lot to do with money-printing (which causes inflation) and the debt that's accrued since WW II. Imagine the distortions in our real economy. "Where's the risk in equity markets?" we're asked on CNBC. "Where is it not?" would be a better question. And to be clear, GDP growth looks so horrible because we are subtracting all of the debt we had to take on in the aftermath of the Great Recession. We simply didn't get a lot of bang for our buck in terms of economic growth. Debt is not income, so a real GDP number net of loan proceeds looks abysmal.



The Stock Market

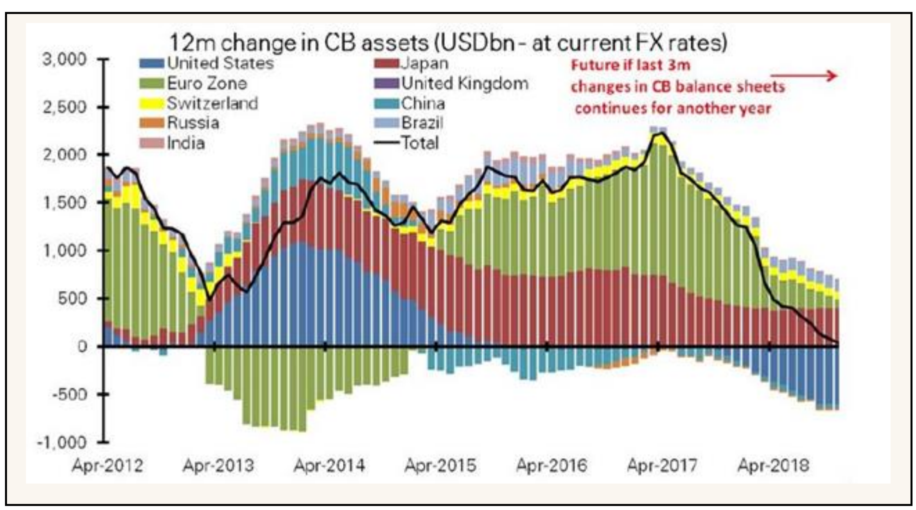
The stock market is the primary beneficiary of all the money-printing we've seen over the last few years. The Fed has placed an artificial premium on being in stocks up until it ended its Quantitative Easing (QE) program in late 2014. And the reason we've had such a lackluster recovery is exactly due to the premium they've placed on stocks. It's effectively sucked all the available capital from the real sector, where production occurs, and it's gone into the seemingly risk-free stock market. Imagine the distortion that's created! It's fostered an environment where people would rather speculate than manufacture and gamble rather than produce.

If there were a constant amount of money in the economy, or if we had a gold standard, the stock market would rarely go up in aggregate. Think about that for a second. If we did not print money out of thin air like it was a game, the stock market would never go up in aggregate. Some stocks would go up and others would go down, so that on the whole, the market could never go up all at once. Vanguard, who've made their existence in index funds, would not exist – not in its current form anyway. Index funds would be non-existent.

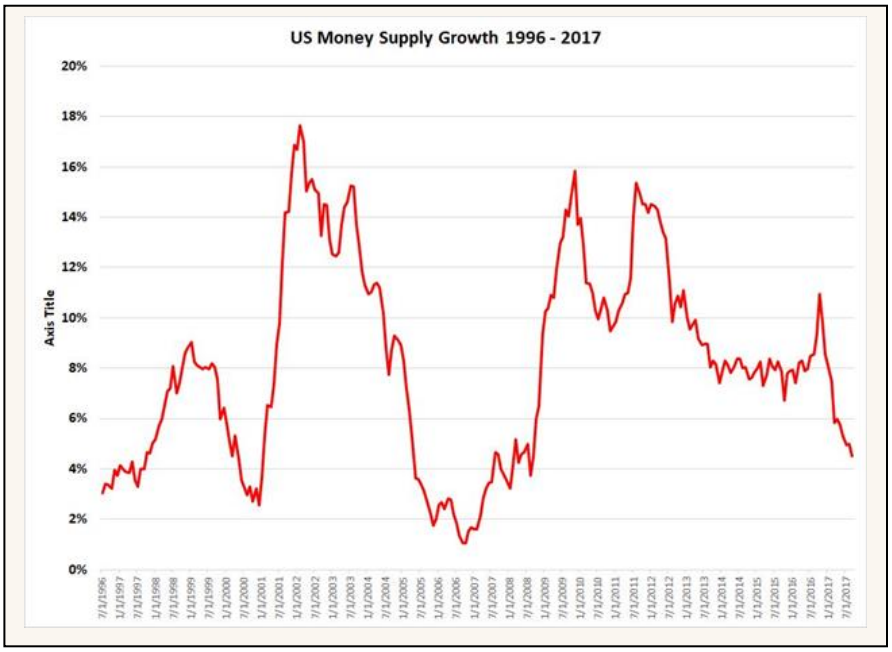
To make money in stocks, you'd have to pick the actual winners in the economy, as opposed to tossing darts at the Wall St. Journal. The companies that were truly innovative in bringing the consumer what she truly wants would win, while its competitors would lose. Money that bought Amazon stock would necessarily have to come from IBM stock. Amazon would win and IBM would lose. They'd cancel out each other, on net.

The only way a stock market can go up in aggregate is with new money being created (or positive technology shocks). So, it makes sense then, to look at the stock market, deflated by the money supply, which is admittedly more of a thought experiment because foreign money can go into our stocks as well as our own freshly-printed greenbacks. But including foreign money would only make the following chart look worse.

Since 1959, the US stock market is up 450%. Pretty good, right? But money supply is up over the same time by 350%. Adjusting for money supply – inflation – the market is up just 11% over 58 years. In other words, 439% of the stock markets 450% rise is due solely to US money-printing. The other 11% is actual gains in economic efficiency, or due to foreign money. That's less than 2/10 of 1% per year. If you don't quite get that, please read it again. This conclusion means that if you're long stocks right now, you should stop for a second and realize that the market going up – in aggregate - is dependent primarily on money-printing. Trump's economic agenda will be great for Americans and the economy, but the stock market as a whole needs money-printing to go along with that enthusiasm. It therefore means you'd better follow the money supply and if you do, you ain't gonna like what's goin' on. This particular illusion is likely going to change, if not end.



World stock markets have benefited from global money-printing through various countries' Quantitative Easing programs. When a country engages in QE, it buys bonds from banks and pays the banks with money created out of thin air. The net effect is more money for banks and more assets held by the central bank. They bought bonds, and bonds are an asset. As the chart shows, $2 trillion has been injected into the economy from various global QE programs in the 12 months ending in early summer of 2017. The chart shows the total assets on central bank balance sheets and that's another way of showing how much money they created. And the recent $2 trillion is a lot of money and it explains the global stock market rallies. But we are now on the descent. Some central banks are phasing out QE and some countries like the US, are actually starting to quantitatively tighten, by selling bonds back to the market – bearish for stocks.



Here's what's important. By late 2018, there will be virtually no more injections. And by early 2019, we will actually see a net negative injection – net selling of bonds and, thereby, a net removal of money from the system. And guess what's already going on the US? Money supply growth is already decelerating. As you can see from the chart, it's at a 9-year low.

So, let's review the landscape for stocks in the US currently. Distortions and euphoria abound.

Sentiment is euphoric. We set a record for stock market expectations over the next 12 months on a recent University of Michigan Consumer Sentiment Survey. Now, we don't have a lot of data here, but going back to 2000, we've never been more euphoric.

The American Association for Individual Investors has recently showed the lowest level of cash in investor portfolios since 2000. In other words, the small investor has bought up all the stocks they can. There is no more "cash on the sidelines."

There is a new bullish extreme for the five-day average of Market Vane's Bullish Consensus survey of advisors. On September 15, 2017 the average pushed to 71%, a new ten-year extreme. So, advisors are telling their clients to buy up as many stocks as they possibly can, or at least 71% of them are saying this. We are not one of the 71%.

A recent Commitment of Traders Report shows that Large Speculators in futures on the CBOE Volatility Index (VIX) have amassed a record net-short position of 172,395 contracts. This means that more than ever, there is confidence that nothing can go wrong and that risk are as low as has ever been the case.

Large Speculators in the E-mini Dow Jones Industrial Average futures have recently pushed their net-long position to 95,976 contracts, more than four times the number of contracts they held in January 2008, shortly after the Dow started its largest percentage decline since 1929. This is a more popular contract than in 2008, but still, the enthusiasm builds for stocks.

Standard valuation techniques show the highest valuation levels ever, save the dot.com / tech bubble – which is the standard-bearer of bubbles. As of this writing, on a price-to-sales basis, would you believe that we're only 3% away from eclipsing the grotesque valuations of the dot-com bubble – the highest valuations based on sales ever? We could go on and on. The distortions are seemingly endless.

Conclusion

So, what's the point? There are a few points, actually. First and foremost, this system needs reforms and it needs changes. It's not a healthy system. Money-printing and debt accumulation have distorted incentives and created risk where an honest-money system would not. We are optimistic that more and more people are aware of the problems and that a fix can be affected, given a re-education of the public. This is difficult stuff for most people and that's understandable, but the message must be delivered anyway; the attempt must be made.

Our intent is not to scare the dickens out of people, but rather to open their eyes. What their eyes will see is not pleasant to be sure, but it is reality, stripped bare of illusion. And you can help protect yourself. You can be extremely diversified. You can follow the trends with a willingness to shift directions when necessary and prudent. You can reduce the risk you're taking, while understanding that risk must still be taken. You can look for investments with guarantees. You can own hedges against risk. In short, there's a lot you can do.

And we should mention that the world is full of smart people – very intelligent people, actually – who would disagree with this analysis. But it's not strictly a matter of intelligence that's at issue here. It's ignorance. So many academics and policy-makers have never even been exposed to this train of thought and method of analysis. And, it's a matter of cognitive biases. People by and large believe what they want to believe, which is why many intelligent people in our industry have never considered this line of thinking – they haven't looked for a dissenting opinion.

We are not saying that doom awaits us, and we're not saying that any big market sell-off is imminent. We are only saying that valuations are so high and the system so distorted, that we would be wise to reassess the investment risk we're taking. After all, we are long stocks, but we're also well-diversified.

Even if we were to have a systemic "break" somewhere, we may see authorities rush to the rescue. We'd think the powers-that-be have a Plan B and Plan C at the ready. In fact, if net money-injection starts to go negative and nasty consequences ensue, many central banks will begin the injections again. Other central banks may start buying more stocks than they currently are. The Swiss National Bank currently owns $88 billion of US stocks. Japan routinely buys shares of that country's REIT exchange-traded funds (ETFs). That could all keep the illusion going for an indefinite period. Or in the next 12 months or so, there could be a technology brought to market that truly does change our lives for the better and give stocks a great reason to be going up. But that would still require money-printing. And all of these "fixes" simply keep the illusion going. But that might buy time to have a real conversation on a global scale as to how best fix the distortions already created.

So, the main point in this discourse is to bring a little sanity back to the risk-taking in markets. Despite what the VIX says, there are plenty of reasons for concern. We must take risk, yes. But how we manage the risk is completely up to us and the first step in managing risk is to know what those risks are. We hope we've done that. Once we have an idea of the risks we need to have a plan to address them in our investments.

What to Do Now

You should call Butler, Lanz & Wagler at **(913) 696-1919**. And, you should probably do it now. We know many people say, "I'll wait to think seriously about my investments until the Apocalypse starts." If that's you, please consider that by the time you realize a serious market sell-off has started, it may be too late to avoid all or even some of it.

We believe that there must be a resetting of the current markets back to some semblance of economic value. We would not recommend you wait for signs of that either. It's difficult to know if markets are simply pulling back, or if it will lead to a bigger drawdown. More importantly, with the right approach, there's no need to wait. It can make money if markets boom and it can make money if they collapse. So why wait?

While a complete and total meltdown of the US economy is still a reasonably low probability, the risks of a "garden variety" financial or economic crisis are rising. One way to hedge against this is our all-weather approach. This is an extremely diversified portfolio that can take bullish, bearish or cash positions in numerous asset classes. In our opinion, it's the best way to allocate risk assets for growth. It can do well in both an unfavorable environment and a "rosy" economic scenario. But it's not the only thing investors can do to be well-diversified and prepared for any economic environment. We've been talking about a three-bucket approach for the some time which features, in addition to risk assets (the All-Weather Growth Portfolio fits here), guaranteed assets and income producing assets. When you schedule a meeting, we can talk about each of these buckets.

Call **(913) 696-1919** to schedule a free one-hour consultation where we'll talk about ways to address this environment in detail, if you'd like. And, we'll talk about your situation. There are several advantages to coming into our offices and discuss what it would be like to have a professional money management firm handle your investments:

1) It's free, so you'll pay nothing to check us out.
2) It's confidential – we won't sell your name or pester you if you decide we are not a good fit.
3) You'll have an opportunity to go over our money management style in much more detail.
4) It's your opportunity to interview us. Ask us whatever you want.
5) We can give you our opinion on how you're currently situated versus where we would have you positioned.

So now that you know the some of the risks to this market, shouldn't you take a second look to make sure you have a plan that addresses it? To learn more about what we can do for you, simply call (913) 696-1919 and schedule a free one-hour consultation. We'll look forward to seeing you then.