

Leithner Letter No. 84-86

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Wilfully or not, the Bush administration seems to have ignored the two biggest economic lessons of the Nixon era: artificial stimulation of the economy, via tax or interest-rate cuts, almost always backfires; and running deficits can be dangerous, particularly when foreigners finance them ... We've revived the stock market, but at a tremendous cost to our national balance sheet. The real bear market is ahead of us, not behind us.

“That 70’s Show”
Barron’s (17 November 2003)

The economic situation today is reminiscent of the 1970s. The economic malaise of that era resulted from the profligacy of the 1960s, when Congress wildly expanded the welfare state and fought an expensive war in Southeast Asia. Large federal deficits led to stagflation – a combination of high price inflation, high interest rates, high unemployment, and stagnant economic growth ... I fear that today’s economic fundamentals are worse than [those of] the 1970s: federal deficits are higher, the supply of fiat dollars is much greater, and personal savings rates are much lower. If the federal government won’t stop spending, borrowing, printing and taxing, we may find ourselves in far worse shape than 30 years ago.

Congressman Ron Paul (Republican-Texas)
[Deficits Make You Poorer](#) (14 March 2005)

“The U.S. economy and global economy,” says Abby Joseph Cohen, “are facing points of inflexion. The longstanding period of disinflation is over ... The longstanding multi-decade period of lower interest rates is over.” In fact, from an investment viewpoint, she agrees with the view that interest rates, price-earnings [ratios], productivity, profit share of GDP and corporate profit margins are all at an inflexion point where they can’t get any better. “I agree wholeheartedly,” she says. “The question is: how quickly will they deteriorate?”

The Australian Financial Review
(4-5 November 2006)

Of Black Swans and Other Disconfirming Events

The end of one calendar year and the beginning of the next is an appropriate time to reflect upon the outgoing year's twists and turns, triumphs, trials and tribulations. It is also a good time to place these things into a broader context, consider their possible causes and consequences, learn one's lessons and set a course for the twelve months to come. With this objective in mind, and focussing upon finance and investments in Australia (and to greater or lesser extents Britain, Canada, New Zealand and the U.S.), it seems to me that four points remain most salient. None is particularly cheery. So if you strive to radiate merriness and festiveness at this time of year, put this Letter aside until after the holidays.

Considered as a whole, these points remind us that investors mind risks and let results mind themselves (speculators, in contrast, discount risks and chase returns). They therefore yield a cautious stance rather than a confident forecast. But it is important to acknowledge that I also expressed dour sentiments about 2003, 2004 and 2005, and that they have not, by and large, been vindicated (see, for example, [Letters 72-73](#)). Our guns have been loaded and our powder dry, but no herds of exquisite wildlife have stormed across our paddocks. Instead, we've had to content ourselves with the occasional straggler, loner, bitser and lost sheep. Fortunately, these cautious actions have not harmed Leithner & Co.'s results. Quite the opposite: in absolute and relative terms, prudence and scepticism have underwritten reasonable short- and medium-term returns on its shareholders' equity ([click here](#) for a summary).

A Country of Credit Junkies

As a first point, since 1999 Leithner & Co. has believed – and going into 2007 continues to believe – that economic conditions in Australia are superficially robust but fundamentally fragile. Appearances are misleading ultimately because much of today's economic activity stems from discredited ideas of yesteryear. The central problem is not just that, no matter how comprehensively they were disproved during the 18th and 19th centuries, the same old myths constantly reappear in deceptively authoritative guises (see, for example, [The Legacy of Lord Keynes](#) by William Peterson and the discussion of [Say's Law](#) in [Letter 64](#)). The problem is also that these falsehoods have attained the status of unchallengeable orthodoxy. Despite all the logic and evidence to the contrary, all and sundry (including the great and powerful) insist that consumer and government expenditure causes prosperity; that central banks' suspension of the natural rate of interest and aggressive creation of credit not backed by savings underwrites growth (or prevents "slowdowns" or mitigates them when they occur); and that an increase of an asset's price enlarges its owner's wealth.

The long expansion since the early 1990s, during which growth (defined in the conventional way) has proceeded virtually without interruption, thus masks important and growing weaknesses. A robust business cycle – both its ups and

downs! – is as salutary as it is inevitable. Hence the fact that fifteen years have passed since the country has experienced a bracing recession and cleansing bear market does not herald the success of our rulers’ policies: it merely affirms the artificiality of what they have wrought. Today, the most important weaknesses are the exposure of households and businesses to the insidious consequences of inflation. This vulnerability takes the form of multiple asset “bubbles” (which eventually burst); artificial profits, particularly in the financial services sector (which sooner or later implode); and the steadily weakening financial position of many households (which in due course must be repaired and rebuilt). By attempting to perpetuate the boom, our rulers will worsen the eventual bust.

The inflation of the Reserve Bank of Australia and its counterparts internationally, and the resultant creation by commercial banks of vast quantities of credit not backed by savings (see [Letter 67](#)), has primed and fuelled Australia’s long boom. The resultant galloping prices of financial assets and the exuberant expenditure of consumers and governments have ignited the boom. One factor has fed another – and has thereby, indirectly and circuitously, fed itself. Inflation, for example, has put massive amounts of credit into consumers’ hands; among other things, they have used it to finance the Great Aussie Dream; and as a result the price of residential real estate has skyrocketed. Allegedly escalating household wealth has encouraged Australians to extract equity from their household balance sheets and to spend the proceeds on fancy cars, lavish renovations and other items of conspicuous consumption. The tsunami of credit has also unleashed a frenzy of financial engineering, which has facilitated historically very high levels of corporate profitability; and the government has taxed these profits and recycled them into the usual pyramids, welfare, warfare and other boondoggles, rorts, bribes and rewards for its various puppets and mascots.

The trouble is that this frenzy of expenditure, rising asset prices and profits depends upon the perpetuation of the central bank’s policy of inflation. And the RBA, falsely thinking that the rising prices of houses and stocks have bolstered Australians’ financial position (and correctly concluding that the tide of tax revenue pleases its master in Canberra), has happily obliged.

Alas, the ideas that underlie Australia’s boom are – to put it mildly – suspect. Most notably, hearty consumer spending is a *consequence* and not a *cause* of prosperity; and to confuse this sequence of cause and effect – particularly when credit rather than savings finance the expenditure – is typically to eat one’s seed corn. But depleting one’s pool of funding is a recipe for disaster rather than success (see in particular [A Tale of Two Islands](#) and [The Robinson Crusoe Ethic Versus the Distemper of Our Times](#)). Those who think otherwise, who are legion in this country, should ponder the words of Ludwig von Mises: “It may sometimes be expedient for a man to heat the stove with his furniture. But he should not delude himself by believing that he has discovered a wonderful new method of heating his premises.” Further, minuscule is the number of people who recognise that government regulations and expenditures always and everywhere create waste and harm, and are thus a recipe for penury rather than prosperity (see, for example, [Sir](#)

John Cowperthwaite: The Man Who Brought Freedom to Hong Kong and Big Government Means Slower Growth).

Australians' gilded prosperity, in short, glorifies blind faith in and dependence upon government, borrowing, spending and the impulse to have it all now. It thereby disparages scepticism, vigilance, independence, the postponement of gratification, the discipline of doing without and saving for a rainy day. As a result, Australians depend not just upon indulgent central banks here and abroad; lacking healthy internal sources of savings, they also rely upon foreigners' leniency and goodwill. So ignore the soothing babble of politicians, bureaucrats and pundits: a large and growing addiction to credit not backed by savings neither creates nor signifies economic strength. Quite the contrary, it begets rising vulnerability.

A High-Inflation Country

The second point is that Australians misunderstand inflation and thus misdiagnose its effects. Inflation in Australia has long been much higher and its effects more insidious than is commonly recognised. It increased from 0% in 1992 to 10% in 1996, and thereafter has fluctuated at an average rate of 8-9% per annum (see [Letters 78-80](#)). Abbreviating drastically, inflation is an expansion of the money supply. It is thus an exclusively monetary phenomenon. As Friedrich von Hayek noted in *The Pure Theory of Capital*: "It is self-contradictory to discuss a process [inflation] which could not take place without money and at the same time to assume that money is absent or has no effect." In Australia, a fiat monetary régime reigns: that is, money is whatever the state (rather than individuals acting freely in the market) says it is. In such a system, only central banks can create money: neither you nor I, nor oil companies, farmers or trade unions, can.

Consequently, neither rising oil prices nor mounting food prices nor escalating wage claims cause inflation. Further, central banks do not *fight* inflation: like the firebug who joins the local Bush Fire Brigade, they *create* it. Only they expand the money supply; accordingly, only they create inflation. More generally, the central bank and its inflation is a necessary condition of interventionist government: without it, neither welfare nor warfare can be financed. Governments, one must always remember, never solve problems. At best, they shift them and at worst (which is most of the time) they aggravate them. Central banks corroborate this iron law: they do not *tame* the business cycle: they *worsen* it.

Inflation's effects are two-fold (see [Letter 68](#)). During its early stages, the overall level of prices (which, as Mark Brandly shows in [Don't Believe Those Inflation Numbers](#), primitive measures like the CPI do not begin to reflect) does not rise as rapidly as the supply of money. If the money supply doubles, for example, then consumer prices might rise by only 50%. This is because individuals' demand for money usually changes much less quickly than the supply of money. Relative to the supply of money, in other words, at the early stages of inflation the demand for money rises and much of the new money created by the inflation is added to cash balances. During this initial stage, the demand for money offsets much of the

upward pressure upon the overall level of prices. *At this first stage, inflation can rage but in response the CPI might increase only modestly.*

In the subsequent phase, these modest increases of the price level will almost invariably go to politicians' and central bankers' heads. They will believe that they can continue to increase the supply of money – indeed, they might think they can increase it even more rapidly – and thereby subsidise their favourite puppets more lavishly, cover their growing deficits and launch ever-expanding wars on poverty, drugs, guns, terrorism, etc. They think they can have welfare, warfare and only modestly rising prices. But these things cannot continue indefinitely because the public's reaction to the government's inflation inexorably changes. Perhaps jolted by unexpectedly sudden and large rises of “sensitive” prices, such as petrol, individuals belatedly think to themselves “goodness me, the price of fuel is rising more than usual. Come to think of it, so too are the prices of many other things that I buy regularly. I'm beginning to believe that during the next several years prices will rise more rapidly than they have over the past several years.” The public's expectations of relatively stable or modestly rising prices thus transform themselves into expectations of more rapidly rising prices.

Given these expectations, people will no longer (as they typically did in the 19th century) cumulate savings and wait for prices to fall. Instead, and in anticipation of higher prices tomorrow, their incentive is to redouble their spending and deplete their cash balances. At this subsequent phase of inflation, when prices rise as quickly as or more rapidly than the supply of money, a high and perhaps even rising demand for money no longer attenuates price increases. Quite the contrary: falling demand begins to fuel these rises. Given some constant rate of inflation, people's expectations about future prices, having detected and begun to adjust to the insidious consequences of the central bank's past and present policy, now prompt the overall increase of prices to accelerate. The critical point, which nobody in Oz – including its central bankers – appears to recognise, is that a rising CPI is an *eventual consequence of yesterday's inflation*, but it is *not the same thing as today's inflation*. Alas, if investors possess no understanding of the causes of inflation then they render themselves vulnerable to (and prone to surprise about) its insidious consequences.

The Lucky Country, 2003-2006: You See a Boom; I See the Seeds of Bust

Our third and fourth points follow closely from the second. The third is that inflation always begets recession (see, for example, [Inflation and Deflation: Some Dissenting Thoughts for Value Investors](#) and [Rethinking the Great Depression: Implications for Value Investors](#)). The central bank can cease its policy of inflation any time it pleases – but only by triggering a disinflationary recession. “Disinflation” is a policy whereby the central bank decelerates or perhaps even (rarely) halts the rate of growth of the money supply. How does it restrain monetary growth? Simplifying greatly, it undertakes one or more of a set of actions that place upward pressure upon interest rates. To decelerate the growth of money is to moderate the supply of credit. This, in a country like Australia that

depends heavily upon the availability of credit (and therefore where its demand is relatively inelastic vis-à-vis its supply) increases its cost.

How to increase the cost of credit? Commercial banks stiffen collateral and other terms, shorten the duration of loans and increase their rate of interest. Hence our fourth point: a consequence of the RBA's inflation, namely a massive and artificial increase of the supply of credit relative to the supply of savings, suppresses the price of credit. In plain English, interest rates in Australia have long been and remain artificially low. Accordingly, as the chickens of the central bank's decade-long campaign of inflation come home to roost – that is, as the prices of producer goods, wages and consumer goods rise more quickly than previously – upward pressure upon interest rates will intensify.

But why, complain commercial bankers, property developers, mortgage debtors, politicians and other leading members of the coalition of credit, must interest rates rise? Does the RBA have no heart? It is not just the revised policy of the central bank, but also the unrepentant behaviour of complaining borrowers, that boosts rates. If banks restrain the supply of credit, but borrowers' demand for it remains constant or even increases, then its price will rise.

When not upset by central and commercial banks, the structure of production at any particular time tends to be just long enough to exhaust the fund of savings generated by the natural rate of interest (for details, see [Letter 51](#)). But in a régime of fiat money, banks necessarily derange this structure; further, the future is unknowable, bank error inevitable and hence a perfect match between the natural rate and the structure highly unlikely. If the structure is too short relative to the rate (that is, on those extremely rare occasions when central and commercial banks generate interest rates above their free market level), unused capital will be available for deployment on marginal projects. Given unduly high rates of interest, viable and profitable investments never see the light of day. But if the structure is too long relative to the rate (that is, when banks depress rates, as they virtually always connive to do), then the available capital will be expended before production has been completed. Given artificially low rates, in other words, uneconomical and unprofitable projects will receive the green light.

The situation under these latter circumstances resembles that of a builder who has completed the foundations of a house and belatedly discovers, once much of the superstructure has been raised, that he has insufficient materials to complete it. To finish such projects, and reassured by the apparent boom, entrepreneurs attempt to borrow more at artificially low rates of interest. Sooner or later, however, either commercial banks (worried about the steadily declining quality of credit and the declining profit margins borne of banks' frenzied competition to extend credit) or the central bank (fearful of increases of the prices of goods, services or wages, which it mistakenly calls "inflation") will halt the boom. The central bank will increase the short-term rate of interest it controls (in Australia, the Overnight Cash Rate is the rate banks charge one another to lend excess reserves), and commercial banks will impose higher rates and stiffer terms upon borrowers.

As rates rise, the unviable nature of these incomplete projects becomes apparent. Investors either abandon them or, in a futile attempt to complete them, drive themselves into bankruptcy. Hence unfinished projects – ranging from vacant building sites and repossessed homes to myriad ventures that fail to achieve their objectives – and the loss of money, retrenchment and liquidation that follow in their wakes are hallmarks of the recession (bust) caused by the boom which was unleashed by the central bank's inflation.

Note, then, something that utterly escapes the mainstream: when the boom ends, it does not suddenly *cause* difficulties: it merely *reveals* problems that inhered all along in the inflation and artificially low rates of interest. The only antidote to the policy of inflation is to halt the inflation; and this cessation necessarily entails higher interest rates. Also note that the hue and cry for lower rates that invariably appears after the crest of the boom belies ignorance about the single cause and multiple effects of inflation. *Hence decreasing the OCR – i.e., accelerating inflation and perhaps reigniting the boom, as central banks did in 2002-2004, simply sets the stage for an even more severe bust down the track.* The trouble with gilded prosperity, in short, is not that it is a period of good business; rather, it is an irrationally exuberant time when capital is squandered on bad investments.

Is Stagflation Our Destiny?

The bad news doesn't end there. Just as the central bank's inflation does not have an immediate impact upon consumer prices, so too will its policy of disinflation – if, indeed, it adopts such a policy, which to date the RBA hasn't [Letters 78-80](#)) – take time to influence consumers. Accordingly, and regardless of the arm flapping and hand wringing and interventionism of the central bank, consumer prices and longer-term bond rates can rise during the recession. This is why conventional economists' moods soured during the 1970s and early 1980s: things that their patron saint, John Maynard Keynes, assured them could never occur together nonetheless appeared simultaneously. There was not just recession and rising unemployment, but also soaring interest rates and CPI.

But won't the substantial (25% or more) fall in the price of oil since the middle of July restrain the CPI? Won't the lower CPI caused by cheaper petrol provide the "cover" central banks require in order to reduce the OCR? These days, legions of investors, commentators and central bankers complacently assume so. More generally, most people believe (or are at least prepared to accept) that sudden and significant changes in the prices of major goods and services, such as oil, affect the overall price level. Alas, few recognise that this contention is doubtful and potentially harmful. The recessions of the 1970s and 1980s, it is now clear, had nothing to do with the "oil shocks" that punctuated these years.

The contention that a change of the price of oil affects the CPI encourages investors to believe that central banks have nothing to do with inflation. According to the mainstream, inflation is something caused by price movements

of particular (or major categories of) goods and services; and these movements, in turn, are consequences of unpredictable world events or other (and often inexplicable) changes of demand and supply. Given a proper (classical and Austrian) conception of inflation, however, it is obvious that this contention confuses cause and effect. A rising oil price does not cause the CPI to rise, but the central bank's inflation can (and eventually will) cause the price of oil (and the CPI more generally) to rise. It is simply a myth that the CPI is somehow led around by the nose by major sectors such as energy, food, etc., and that inflation has nothing to do with the money supply – or with central banks.

This mainstream contention also distracts investors' attention from elementary economics. Consider Scenario A. If the price of oil rises, and if consumers wish to use the same amount of oil as before, then they must allocate more money to oil. If people's stock of money remains unchanged, then less money is available for other goods and services, the quantity demanded of those goods and services falls, and thus their prices tend to *decrease*. The additional money now spent on dearer oil cannot be spent on other goods and services. The flow of expenditure towards oil counteracts the one away from everything else, and the falling prices of other things are commensurate with the rising price of oil, such that the overall price level does not change. Now consider Scenario B, which is identical to A except for one thing: the stock of money rises. If so, then more money will be spent on the unchanged stock of goods – which means that, overall, prices tend to *increase*.

Note in Scenario A that the composition of spending has altered, but the price level remains unchanged. Absent inflation, individual prices will change but the overall price level will not. But in Scenario B, where inflation occurs (and thereby conforms to reality much more closely than A), overall prices rise; and the extent of this rise will be influenced by the rate of growth of money supply – and not by the increase of the price of any particular good. In short, a rising price of oil or of any other good or service doesn't cause inflation; but it is a possible consequence of inflation. Similarly, a falling price of oil doesn't cause inflation to decelerate. Today's price level does not depend upon yesterday's price of oil or bananas: it is a consequence of yesterday's inflation of the money supply. To the extent that the price of oil and the CPI are correlated, it is because they are common effects of a single cause: the central bank's inflation.

For these reasons, Leithner & Co. continues to incorporate the possibility of “stagflation” (the simultaneous occurrence of stagnation, and rising consumer prices and interest rates) into its investment plans. If economic conditions in Australia really are superficially strong but rest upon weak foundations, if inflation in this country has indeed long been much higher and its effects more insidious than is commonly recognised, and if inflation always begets recession, then the prospects for securities' prices during the next several years – and the returns of investors who have bought at these prices – are distinctly less than rosy. The fourth and final point is thus that the prices of most financial assets in Australia, including stocks, bonds and commercial and residential real estate, are prone to

downward shocks. Hence the Company's outlook for 2007, like that of previous years, remains cautious and even dour.

Ahead of the Pack or Just Plain Wrong?

"I have known a great many troubles," Mark Twain allegedly said, "but most of them never happened." Applying this insight to the recent history of Australian financial markets, during the first six months of 2006 (and most of 2004 and 2005) bullishness was much more remunerative than bearishness. That is, people who have discounted, denied or ignored risks, and who have accentuated the positive, have generally enjoyed better results than people who have regarded the economic and financial glass as half-empty (and also cracked and thus prone to the leakage of liquid). Further, and as a friend recently wrote to a discussion group, "I am reminded of a columnist ... [who] every year would receive a number of letters, mostly from retired professors of mathematics, predicting that a financial crisis would occur during the coming year. She also made reference to various financial writers who had made [such] forecasts. What happens each year, she continued? When their forecast doesn't come true, they roll the same forecast out for the next year."

Most of what passes for analysis of economics, investment and finance, whether its authors are professionals or amateurs, and whether they are confident, neutral or cautious, is, to various degrees, idiotic or guesswork or both. None of it consistently foretells, or is capable of predicting, the future with any useful degree of accuracy. If so, and if for the past few years confidence has trumped caution, then why cloud one's mind with vigilance? Why not let the trend be your friend? Today's bulls rightly note that since 2003 they have (with respect to the overall direction of securities' prices) been mostly correct and bears mostly wrong. It therefore makes sense that bulls ask "why on earth should I believe that an investment in scepticism and prudence will pay dividends in 2007?"

What is the bears' problem, anyway? Are the wild excesses of the past several years figments of their imaginations? If they exist, do these extremes require more time than expected to bear their bitter fruit? Have various intervening factors, such as China's boom and its willingness to finance American and other extravagances, bought breathing room? Is capitalism – even today's heavily hobbled and grotesquely bastardised variant – much more resilient than even the staunchest defenders of laissez-faire recognise? Are the economics of the Austrian School wrong and the approach to the allocation of capital pioneered by Benjamin Graham is outmoded? Or have I simply misunderstood or misapplied these ideas?

During the past several months, and as dispassionately as the ego permits, I have pondered these questions. I have concluded that the case for caution is certainly bruised, perhaps even battered, but hardly beaten. The contention that the prices of most securities are excessive has obviously corresponded poorly to reality (in the sense that during 2006 market participants have bid these allegedly unwarranted prices even higher). Yet the premises that yield this conclusion have

not strayed too far from reality – and, indeed, during the past six months they have reflected it reasonably well.

At the end of 2006, and despite the seemingly relentless bullishness of its equity and bond markets, the pressure upon economic conditions in Australia is generally downward. At various points during the year, albeit in different ways and to varying extents, even the heads of the RBA and Treasury stressed that a “slowdown” will be more likely than a reacceleration. Further, the PPI, CPI and OCR are rising.

Speaking of interest rates, the yield curve remains resolutely inverted (see [Letter 66](#)). Indeed, during the past six months the inversion has steepened. Since the Second World War in most Western countries including Australia, the yield curve has tended to invert roughly 6-18 months before the onset of recession (for a recent summary of this literature, see Paul Cwik, [An Investigation of Inverted Yield Curves and Economic Downturns](#)). An inversion today does not necessarily mean recession tomorrow; but a recession is almost always preceded by an inversion. Japan since the 1980s is the major exception – perhaps because during most of this period it has been mired in recession.

Since the Australian curve inverted late in 2004, various people (some quite influential) have used *ad hoc* rationales rather than rigorous logical and empirical grounds to assert that, in effect, this time it’s different. But perhaps to no avail: the wolf of recession may now be howling in front of some doors. Abetted by the worst drought in a century, Australia’s agricultural and pastoral industries may be among his first ports of call. More generally, for much of 2006 three states (New South Wales, South Australia and Tasmania) have hovered on the verge of downturn; another, Victoria, is in the doldrums; and across Australia, the manufacturing sector is at best sluggish.

The mining sector is the obvious and dramatic exception to this overall picture of lethargy. Hence Western Australia, Queensland and the Liberal-National coalition in Canberra can thank their lucky stars that, as if on cue, the biggest mining bonanza in at least 30 years commenced in 2003. As *The Australian Financial Review* (3 November) put it, “the commodities boom [came] along just in time to save Australia from recession at the end of the housing boom, and delivered a massive boost to incomes and government revenues, Access Economics director Chris Richardson told the Melbourne Institute of Applied Economic and Social’s Making the Boom Pay conference in Melbourne yesterday.” Several speakers at the conference concurred that Australian governments have squandered the fruits of the boom. They agreed that the boom will end, but did not know when.

What is clear, however, is that, once the boom ends, the policies of the Commonwealth and states will worsen the downturn. “Australia [risks] being unprepared for such a downturn because the federal government has spent most of the revenue windfall from the boom – \$47 billion for this year alone – on consumption, interest rates are rising, house prices and the current account deficit

are still stretched, the momentum from past reforms is spent and governments have no stomach for [further] reform ... Mr Richardson said ‘We can do better than this ... Our time in the economic sunshine is running out.’” Ross Garnaut of The Australian National University added “We will have to reacquaint ourselves with hard choices. If we do not [adjust] promptly, the financial and labour markets will do the adjusting for us. We will regret the passing of a remarkable period of Australian prosperity.”

The most recent batch of national accounts data, released during the first week of September, anticipated the tenor of these comments and thus provided meagre fodder for the bulls. These figures showed – never mind the mining boom! – that Australia’s GDP is expanding at the slowest pace, a rate of 1.9% per annum, in five years. In contrast, price data released during October indicate that the CPI is marching at its briskest speed, 3.9% per year, since 2000. The CPI’s rise remains well above the RBA’s target (2-3% per year) and – judging from the most recent Producer Price Index figures – is likely to increase further during the next 6-12 months. Reacting to these trends, one consternated economist said “We are left with the impression that the economy is not as strong as we previously thought. At the same time, inflationary pressures also appear to be more widespread than we had considered likely.”

As *The Australian* (“Keep the ‘S’ Word in Reserve,” 7 September) put it, “slowing growth and rising prices is not a good look, particularly if you happen to be a central banker.” And especially, one might hasten to add, if your turn at the helm began at the beginning of September. Stagflation befuddled economists during the 1970s. Since then, it seems, they have learnt little or nothing about its causes (see in particular Frank Shostak, [Did Phelps Really Explain Stagflation?](#)) and if it reappears then it will likely baffle them again. Perhaps it has already begun to do so. “To talk about stagflation in Australia’s current circumstances is silly ... There is, however, a puzzling contradiction between our inflation numbers and our below-trend GDP growth. Both can’t be right. In fact, yesterday’s figures were the cause of a lot of head scratching in both Canberra and Martin Place.” Memo to bulls: befuddlement is not a firm base for conviction. After all, a bull cannot easily charge whilst it’s scratching its head.

Another sobering point for the bulls to contemplate: if bond yields, corporate earnings, price multiples and investment returns eventually regress towards their historical means, then financial markets in Australia presently offer precious little value (see in particular see [Letters 78-80](#)). So never mind what the financial press, particularly *The Australian Financial Review*, says about the price multiple of the All Ordinaries Index. Yes, this multiple (presently roughly 14 times earnings) is very close to its historical average. Tellingly, however, the bulls always forget to mention that average profit margins and profits’ share of total factor income have reached 30-year highs, and that they exhibit a strong tendency to revert – sometimes quickly – to their historical mean (see [Letter 76](#)). Adjusted for this unusually high profitability, the All Ords’ price-to-earnings ratio is closer to 25

than to 15. Given that the PER also reverts to its mean, this implies that the All Ords is as dear today as the S&P 500 was in 2000.

Nassim Taleb (*Fooled by Randomness: the Hidden Role of Chance in Life and in the Markets*, Thomson, 2004) emphasises the importance – and dangers – of discontinuous or disconfirming events. Taleb also calls these events “Black Swans.” Some cycles can last a long time – perhaps a decade or more. Australian economic expansions of the 1950s and 1960s provide several examples; and the long boom since the early 1990s provides another. In response to events that in retrospect form a pattern, first a few people, then more and finally many people make a lot of money by using a Model that “works” *with respect to that particular cycle*. As an example, perhaps somebody predicts that interest rates will fall, and then implements a program of investment premised upon a model that makes this prediction. Let us say that rates do indeed fall and profits are reaped. Others, observing The Model’s success, adopt it and also achieve success. Let us also say that The Model continues to predict that rates fall; that year after year, they do indeed fall; and as a result ever bigger profits are generated. As time passes and they achieve and cumulate success, the growing legions of proponents of The Model receive ever more acclaim – and assets under management. If they have a stage presence or a flair for publicity, a few among them become recognised as experts, gurus or even geniuses. The success of ever greater numbers of people depends upon the veracity of The Model. Consequently, after a decade or so, people believe that rates simply cannot rise. They cannot because if they did then the many whom The Model has benefited would suffer.

When the cycle breaks (that is, when the major event occurs that violates The Model’s assumptions), human nature makes it difficult to recognise it for what it is – a fundamental parting of the waters that renders the model inapplicable to the new conditions. Unable to abandon the beautiful past and unwilling to face the ugly present, within a comparatively short period of time the people who continue to adhere fervently to The Model can lose as much or more as it earned for them over the years. As long as the trend is your friend, you’re a hero; alas, models that exploit particular trends (as opposed to philosophies founded upon timeless principles) have a finite life span. The trouble is that nobody rings a bell to proclaim when a Black Swan has been spotted and the Model’s time has expired.

What, then, to conclude? How to proceed into 2007? Two principles, it seems to me, remain as applicable as ever. First, investors keep firmly in mind that finance, economics and investment are not quantitative sciences whose practitioners consistently make accurate forecasts. For every economist, “market strategist” and the like there will be an equal and opposed one – and their predictions, if they make predictions, are both likely to be wrong. Second, investors recognise that disclaiming any ability to divine the future with any useful degree of accuracy is no reason to ignore the future. They cope with its inherent uncertainty by considering scenarios – and concentrating upon somewhat pessimistic scenarios – of what *might conceivably* happen (as opposed to predictions of what *will likely* happen). They then use these scenarios (with an emphasis upon the creation of a “margin of

safety” and the protection of the “downside”) to structure their investment operations and portfolio accordingly. Conditions prevailing towards the end of 2006, the logic of the Austrian School, Australian corporate data since the 1960s and the record of success of Grahamite investors since the 1930s – all of these foundations counsel caution.

Albeit unintentionally, so – of all people – does John Howard. During the 1980s, when he was politically on the ropes, Mr Howard famously prophesied that the times would subsequently change to suit him. In effect, Mr Howard asserted that wind would eventually blow into his Model’s sails. And so, since the mid-1990s, it has. Major trends can last a long time – perhaps a decade or even longer. But will the ones that have benefited Mr Howard so greatly remain securely in place? And can his political antennae detect whether the tide that swept him power and glory is receding?

Some of his recent utterings – and not just about the calamity in Iraq – resemble not a chameleon at the top of its game but rather a rodent that has suddenly found itself trapped in a cage of its own construction. Most notably, on 8 August *The Australian* reported “any suggestion Australia could be headed for recession was misguided, [the Prime Minister] said today. There has been growing concern among economists that yesterday’s Reserve Bank decision to raise interest rate a quarter percentage point could push Australia closer to a possible recession. But Mr Howard rejected the concerns due to the strength of the Australian economy. ‘I heard some very misguided talk this morning from somebody ... about recession’ Mr Howard said ... ‘For anybody to be even uttering that in the present circumstances, with the strength of the economy, they are being misguided to say the least.’” We will see.

Of Historical Parallels and Cautious Lessons

As 2007 unfolds, and as always, it will be wise to respect the laws of human action and to recognise that certain episodes of the past might help us, however imperfectly, to navigate the future. What episodes seem to be particularly relevant? Consider four:

1. An unprovoked and increasingly unpopular war launched under false pretences, largely by a privileged and arrogant American political class (supported vociferously by spineless political castes in London and Canberra) and against an increasingly tenacious resistance in an impoverished and distant land about which the warmongers know little;
2. a tsunami of government expenditure, lavished indiscriminately to guns as well as butter, that cheers the mainstream but rankles a minuscule band of **paleolibertarians**;
3. the waning persistence of artificially low rates of interest;
4. a smart rebound of stock and bond prices after a nasty fall; and a growing trade deficit, steadily falling \$US and erratically rising price of gold.

These developments describe contemporary America and the policies of George W. Bush. But they also describe America in 1969-72 and the policies of Richard M. Nixon. If, as Mark Twain counselled, history does not repeat but does rhyme, then it is worth investors' while to ponder whether Mr Bush's policies will produce results similar to Mr Nixon's. Similarly, Australians might ask whether the consequences of John Howard's policies will mirror those of his ideological brothers-in-arms, Gough Whitlam and Malcolm Fraser. All of these scoundrels are, after all, cut from the same aggressively interventionist cloth.

The analogy, of course, is perilous: to say that two sets of policies or periods of time share characteristics a, b and c is hardly to reason validly to the conclusion that they will necessarily share results x, y and z. Perilous or not, the economic comparison between the Nixon and Bush administrations is ominous. In 1970, a year of mild recession, Mr Nixon, with an accommodative central bank blowing briskly at his back, opened a floodgate of expenditure, artificially stimulated economic activity and revived animal spirits in financial markets. In 1972, allegedly a year of strong recovery, Nixon hit the campaign trail and, promising even better times to come, won re-election by an extraordinary landslide.

His second term was correspondingly historic. But it did not unfold in quite the way he intended. In 1973-75 the structure of production, stock and bond markets, South Vietnam – and the Nixon administration itself – collapsed. The ultimate seeds of the disintegration (i.e., the Keynesian policies that generated stagflation and a Machiavellian mindset that spawned felonies at home, war crimes abroad and denials and cover-ups everywhere) had been planted years before. Nixon assiduously fanned its flames, but in both economic and military terms the interventionist kindling was lit during the Kennedy and Johnson presidencies.

The four-fold lesson that emerges from this analogy, if it is valid, is that (1) Australians can find themselves on the losing side of a war; (2) they can also support ruinous economic policies and congregate on the losing side of investments; (3) 1 and 2 can entail years of painful penitence; and (4) because they are remarkably incurious, Australians prefer to forget than to analyse their mistakes. Again and again they dig themselves into similar holes. An important corollary of this lesson is that investors must (but usually neglect to) protect themselves against their rulers' misguided actions. Above all, war – whether against poverty, drugs or terrorism – is just another failed government policy.

A Seasonal Wish for Robust Liberty, Secure Property and Enduring Peace

Leithner & Co., like many of the inhabitants of *Terra Australis*, takes a break during the latter half of December and the first fortnight of January. Best wishes for a pleasant summer and Christmas holiday, a happy New Year, an easygoing Australia Day and a healthy and prosperous 2007.

Chris Leithner