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Inflation is the enemy of capitalism, chiseling away at the foundation of free markets and the laws of supply and demand. It distorts price signals, making retailers look like profiteers and deceiving workers into thinking their wages have gone up. It pushes families into higher income tax brackets without increasing their real consumption opportunities.

In short, inflation undermines capitalism by destroying the rationale for dedicating a portion of today's earnings to savings. Accumulated savings provide the capital that finances projects that generate higher future returns; it's how an economy grows, how a society reaches higher levels of prosperity. But inflation makes suckers out of savers.

The same values that will help America regain its economic footing and get back on the path to productive growth – honesty, reliability, accountability – should be reflected in our money. Economists who promote the government-knows-best approach of Keynesian economics fail to comprehend the damaging consequences of spurring economic activity through a money illusion. Fiscal “stimulus” at the expense of monetary stability may accommodate the principles of the childless British economist who famously quipped, “In the long run, we're all dead.” But it shortchanges future generations by saddling them with undeserved debt obligations.

Judy Shelton
Capitalism Needs a Sound-Money Foundation
The Wall Street Journal (11 February 2009)

[Ludwig von] Mises is most emphatic in laying at the door of governmentally installed central banks the ultimate responsibility for the distortions (and eventually the depressions) which arise out of the expansion of fiduciary media. He refers, in particular, to the practice of considering it the duty of central banks of issue “to shield the banks which expanded circulation credit from the consequences of their conduct,” in order to soften the economic hardships experienced during the crisis.

Mises was caustic in his condemnation of such public policy attitudes. The “practice of intervening for the benefit of banks, rendered insolvent by the crisis, and of the customers of these banks, has resulted in suspending the market forces which could serve to prevent a return of the expansion. If the banks emerge from the crisis unscathed ... what remains to restrain them from embarking once more on an attempt to reduce artificially the interest rate on loans and expand circulation credit?”

In Human Action (1949), Mises developed the thesis that, in the absence of central bank control over the banking system, competition between private banks in the market would tend to limit credit expansion (and thus remove the source of the business cycle aberrations). Government interference in the banking sector is therefore held ultimately responsible for credit expansion.

Israel Kirzner
Ludwig von Mises: The Man and His Economics (2001)
Quoted in *The Wall Street Journal* (25 March 2009)

The Mainstream Declares “Mission Accomplished;” I Remain as Bearish as Ever

On 28 September, during his [testimony to the Senate Economics References Committee](#), a senator asked Glenn Stevens, the Governor of the Reserve Bank of Australia, “Given the devastation and given the challenges that are being put to the Reserve Bank, could you explain exactly why we did not see this [the “Global Financial Crisis”] coming?” Stevens replied:

There were not that many people who accurately forecast that sequence of events. After these sorts of events, it is normal to see a few people pop out and say, ‘I predicted all this.’ But I think that most of those claims could be taken with a certain degree of salt. What I would say is that if you go back several years there were people who were saying things like: ‘There’s leverage building up. There is very skinny compensation for risk being paid to investors. There’s a lot of complexity here. We’re worried.’ The official community of supervisors and central bankers and those who think about stability said things like that for a few years. The thing that they could not do, though, was say: ‘Not only do I have this concern but I can tell you how it’s going to unfold. What will happen is that these American subprime loans will start to go sour. Then there will be a sequence of failures. Then there will be a retreat from risk taking. These concerns will spread to Europe. Then there will be a rescue of the No. 5 American investment bank, but then when No. 4 comes under pressure it will not be rescued. And then after that Armageddon will follow.’ I am not aware of anyone who predicted a sequence of events like that.

That’s astonishing. Because nobody could foretell precisely what (i.e., sub-prime residential mortgages versus commercial mortgages versus credit default swaps versus the U.S. Government’s bankruptcy, etc.) would trigger the GFC, and because nobody could specify exactly where and when the second and third, etc., domino would fall or the specific path the destruction would take, the warnings of yesterday’s naysayers, reprobates and sceptics should be “taken with a certain degree of salt.” So too, by implication, should today’s. Unless foresight is 20-20, in other words, it’s useless. Central bankers, of course, exempt themselves from this standard. The Governor thus – and quite conveniently – bears no responsibility for his intellectual blindness. “Nobody saw the GFC coming,” Stevens seems to say, “so don’t blame me for not seeing it coming.” Never mind a [speech he delivered in June 2007](#) – just weeks before things economic and financial began cracking at the seams – in which he confidently reassured Australians:

Looking ahead, there does not seem to be a high likelihood of the world economy slowing abruptly in the near term. Hence, the external forces at work will in all likelihood continue to be pretty positive. Australian households overall appear to have plenty of disposable income and the confidence to spend it. Business profits are in good shape, and firms will be well placed to continue their high levels of investment as needed. They are also displaying a strong propensity to borrow, with business credit growth at its highest for nearly two decades.

The RBA's most senior central planners didn't just overlook the storm before it struck: they continued to misapprehend it after it arrived. On 12 December 2007, that is, months after the first wave of turbulence commenced, Stevens' deputy, Ric Battelino, did a probably unintentional but certainly credible impersonation of [Mister Magoo](#) (quoted in *The Australian Financial Review*):

My own view is that Australian households are in very good shape. They are not in any way exposed or vulnerable – the structure of assets and liabilities is quite sound. There would obviously be examples of people getting themselves into financial difficulty. But fundamentally, the household sector as a whole is in very good financial shape. We had an adjustment in the housing market over 2005 and 2006, but house prices are now rising again ... and there's no hint the share market is grossly overvalued.

You may recollect that during calendar 2008 the All Ordinaries Index suffered the biggest fall (-45%) in its history.

Unlike Stevens and Battelino – and Alan Greenspan and Ben Bernanke and all the sordid rest – William White, the former chief economist (1995-2008) at the [Bank for International Settlements](#), foresaw the Global Financial Crisis years before it occurred (see in particular [Global Banking Economist Warned of Coming Crisis](#) by Beat Balzli and Michaela Schiessl). He also tried without success to warn his bosses – namely the world's leading central bankers – about the destruction their policies were wreaking. In the early 2000s, White observed the development of bubbles in commercial and residential real estate (and, more generally, in consumption financed by debt rather than income) in the U.S. and elsewhere. He criticised the increasingly impenetrable securitisation of mortgages, denounced banks' ever more risky loans and deplored ratings agencies' lack of credibility. But Alan Greenspan, Ben Bernanke and others simply didn't want to know.

What, in White's view, inflated the Great Bubble? Central bankers' futile attempt to prevent, delay or mitigate the collapse of the Dot Com Bubble. They slashed the rate of interest that they control (which in Australia is called the Overnight Cash rate, the rate at which banks borrow and lend bank reserves). This intervention in credit markets – that is, suppression of rates below the levels that would otherwise have prevailed – was extended and cumulatively massive: within three years, the benchmark rate in the U.S. fell from 6 percent to 1 percent. This, according to White, was the cardinal error. "After the 2001 crash, interest rates were lowered very aggressively and left too low for too long." Main Street was trying to recover from the demise of the Dot Com Bubble and from the shock of 11 September; meanwhile, bureaucrats in central banks and financial markets had begun to inflate the Great Bubble – and thereby to sow the seeds of the GFC. Message to today's bulls: do you see an ominous pattern here? The policies enacted in reaction to the Dot Com Bubble did not cause a sound economic recovery; instead, they inflated the Great Bubble that begat the GFC. Another message to the bulls: what damage will the "stimulus" enacted in a panicked reaction to the GFC – stimulus that's seven times stronger in terms of GDP than the average post-Second World War countercyclical boondoggle – unleash?

As early as August 2003, White implored central bankers to rethink their misguided ways (see in particular William White and Claudio Borio, [Wither Monetary and Financial Stability? The Implications of Evolving Policy Regimes](#)). Largely as a consequence of the deregulation of financial markets in the 1980s, they contended, the inexorable rise of the prices of consumer goods and services was no longer the central banker's principal problem. Rather, the development of "imbalances" in economies and financial markets, which were increasingly emitting earthquake-like tremors (and which, White and Borio hinted, were consequences of central banks' lax monetary policies), were becoming the major challenge. This contention questioned much and rejected some of what Greenspan had preached for years; since mid-2007, it has likely haunted many a central banker. If the "worst scenario materializes, central banks [will] push policy rates to zero and resort to less conventional measures." Even more tellingly – and four full years before it burst – White and Borio identified the rapidly-inflating bubble in the American real estate market as a direct consequence of central banks' policies. Finally, and gloomily for today's bulls, "further stimulus [to combat the dot com bust] has not come free of charge and has raised questions about the sustainability of the recovery."

White was one of a very few economists – and perhaps the only one employed by central banks and was willing to speak his mind! – who recognised that a policy that aims to stabilise consumer prices in the short-term will generate damaging "imbalances" and "disequilibria" (namely bubbles in stock, bond and real estate markets) in the medium- and long term (see in particular "[Is Price Stability Enough?](#)" BIS Working Paper No. 205, April 2006, and "Inflation Stabilisers Destabilise in Long Term," *The Financial Times* 24 May 2006). Interventionism in short, inevitably spawns unintended negative consequences; and the bigger is the intervention the worse are the consequences. Bulls, are you listening?

For decades, the mainstream contended that the alleged stability – namely the absence of another Great Depression – of economy and finance since the Second World War proved the success of their interventionist monetary and fiscal policies. It's now clear that this "stability" was apparent but not real. It did not reflect these policies' *success*: it reflected the *artificiality* of the conditions they created. For seven decades, Soviet Communism was also "stable." But it was hardly durable, and its sudden and unexpected (to the mainstream) collapse demonstrated – just as Ludwig von Mises foresaw in [Economic Calculation in the Socialist Commonwealth](#) (1920) and in [Socialism: An Economic and Sociological Analysis](#) (1922) – that it had always been unworkable. Similarly, an increase of the Consumer Price Index of ca. 2-3% per annum, which the mainstream invariably confuses with "low inflation," is not a sufficient condition that all's well. (Historically, it's a transition phrase from and to a period when the CPI jogs more quickly.) White warned in 2006 that central banks should not allow the conjunction of historically-low CPI and interest rates to lull them into complacency. After all, both the bankruptcy of Long Term Capital Management and the collapse of stock markets in 2001 occurred "in an environment of effective price stability." So too, it's worth adding, did the Panic of 1907 and the Crash of 1929.

Alas, White was wasting his breath. Roger Ferguson, the Fed's deputy chairman, admonished him: "There are limits to pressing your argument. If you keep repeating your point over and over again, nobody will listen anymore." Ben Bernanke, who succeeded Greenspan early in 2006, was as deaf as Greenspan to White's warnings. When Bernanke presented his biannual report on the state of the economy to Congress on 19 July 2006, he didn't even mention the risk that subprime mortgage would unravel. In December, the BIS reported that the index for securitised subprime mortgages in the U.S. had fallen sharply. A loss of confidence ensued, and in the New Year the first casualties began to surface. On 8 February 2007, HSBC, at the time the world's third-largest bank, cited sub-prime arrears and defaults and issued the first profit warning in its history. On 2 April the mortgage lender New Century Financial filed for bankruptcy. But Bernanke remained unimpressed and unruffled. "The troubles in the subprime sector seem unlikely to seriously spill over to the broader economy or the financial system," he said on 5 June. (Notice that Glenn Stevens uttered his pro forma assurance about the bright future in the same month.)

White made one last, desperate attempt to bring his bosses to their senses. "Virtually no one foresaw the Great Depression of the 1930s, or the crises which affected Japan and Southeast Asia in the early and late 1990s, respectively. In fact, each downturn was preceded by a period of [gilded growth accompanied by relatively stable consumer prices that was] exuberant enough to lead many commentators to suggest that a 'new era' had arrived," he wrote in the BIS's annual report in June 2007. (Similarly, [in 1930 nobody knew that the Great Depression had started.](#)) But even if Bernanke and others had belatedly listened, it would have been too late. On 22 June, the U.S. investment bank Bear Stearns announced that it urgently needed \$3 billion. In Germany, several commercial banks sought government bailouts, and soon thereafter the first run in more than a century effectively felled a British bank. "When the crisis started, I asked myself: Is this the big one?" White recalls. "The answer was: Yes, this is the big one."

At least three years before the panic and the crash, central bankers who bothered to read White's briefs could have known what was happening and how badly it would end. All of the ingredients of the looming disaster had been arranged neatly on the table in front of them: the great and manifold risks of interest rates pushed well below the levels that would prevail in a free market, defective rating agencies, loans repackaged to the point of unrecognisability, dubious practices of American mortgage lenders, etc. But the world's central bankers paid no attention, and leading economists and financial journalists applauded – indeed, deified – them. "You can see all the ingredients of a Greek tragedy," says White.

Since White's departure, the BIS hasn't repudiated his legacy. In its [latest annual report](#), released on 29 June 2009, it reviewed previous banking crises and concluded that sustainable recoveries from such crises require that the banking system take losses, jettison non-performing assets, eliminate excess capacity and rebuild its capital. Unfortunately, "these conditions are not being met and any stimulus will therefore only lead to a temporary pick up in growth followed by

protracted stagnation.” And since his departure, White hasn’t changed his views. On 14 September, he warned ([Economist Warns of Double-Dip Recession](#), *The Financial Times*) that “the world has not tackled the problems at the heart of the economic downturn and is likely to slip back into recession.” What’s more, “government actions to help the economy in the short run may be sowing the seeds for future crises.” He thus spies a double-dip recession: “I would not be in the slightest bit surprised. The only thing that would really surprise me is a rapid and sustainable recovery from the position we’re in.”

William White’s campaign was ultimately futile; nonetheless, he has done three good deeds for Australian investors. First, the views he repeatedly expressed as the chief economist BIS from 2002 to 2008 make mincemeat of Glenn Stevens’ assertion of 28 September. When Stevens says things like “there were not that many people who accurately forecast [the] sequence of events [that caused the Global Financial Crisis],” he’s being disingenuous. That is, he’s a typically clever bureaucrat who talks the language of accountability whilst simultaneously and deftly evading responsibility for the damaging consequences his policies impose upon others. Further, when Stevens says

The official community of supervisors and central bankers and those who think about stability said [things such as “There’s leverage building up. There is very skinny compensation for risk being paid to investors. There’s a lot of complexity here. We’re worried.”] for a few years. The thing that they could not do, though, was say: “Not only do I have this concern but I can tell you how it’s going to unfold. What will happen is that these American subprime loans will start to go sour.” ... I am not aware of anyone who predicted a sequence of events like that.

the dispassionate observer can only conclude that he is either insincere, obtuse or wilfully blind. Perhaps he simply doesn’t read briefs from the BIS. Neither Stevens nor Greenspan or Bernanke, *et al.*, have acknowledged that the chief economist of the “central bank of central banks” warned repeatedly and well before the GFC’s eruption that things were unwell. *Still less have central bankers admitted what White emphasised – namely that central banks’ policies made things unwell.* White correctly foresaw that central banks’ lax policies would cause the crisis, and that disintegrating subprime mortgages would trigger it. He spoke truth to power, and power – including Glenn Stevens – ignored him.

Secondly, Australians would do well to recognise – and never to forget – that the very class of people who caused the crisis but saw nothing coming remain in power. Indeed, two years after the GFC’s eruption, they continue to command all that they survey, their views remain unrevised and unrepentant, and most journalists and economists so enthusiastically swallow what they say that they seldom even bother to chew. As far as central bankers are concerned, since mid-2007 their models haven’t failed: reality has failed. The ability of the world’s monetary central planners to wreak havoc thus remains as potent as ever. Like the Bourbons of old, they have forgotten nothing and learnt nothing. (Glenn Stevens is a member of this Hall of Shame. Before 1990, he held various positions within the RBA; he was an Assistant Governor from 1996 to 2001, was appointed Deputy

Governor in December 2001 and Governor in September 2006.)

Bernanke, Stevens and their mascots in financial institutions and the mainstream media are presently telling us to suspend our ability to think and see. Never mind that they and their predecessors caused the GFC but saw nothing coming. Instead, place blind faith and trust in their assurances that “the worst has passed,” “green shoots” are sprouting, “recovery” is nigh, etc. But Bernanke and Stevens were diametrically wrong in June 2007; why should they be less wrong today? In particular, if the “stimulus” enacted to counteract the Dot Com bust inflated the Great Bubble, then why won’t today’s tsunami of stimulus set the stage for yet another – and even bigger and more painful – bust?

Thirdly, White’s willingness to speak truth to power reminds us that the *raison d’être* of “market economists” and finance journalists is to shill vociferously and mindlessly for the Leviathan state and its pervasive meddling in the economy – and to denigrate anybody who dares to dissent from the orthodoxy of central planning.¹ “The recession is over,” the government’s lapdogs began to enthuse in mid-2009. “We are in recovery now,” Glenn Stevens reassured Senators in late September. The interventionism of the Commonwealth Government and RBA is apparently a model for central planners in other countries. According to *The Weekend Australian* (3-4 October), “Australia’s recession-busting performance may provide a textbook case of how technocratic policy levers can steer an economy through shocks as big as the global financial crisis.”

Also in early October, self-congratulation, giddiness, smugness and outright hubris joined the celebration. On the 9th *The Australian* editorialised: “the recession

¹ “While the world looks on in admiration at our economy’s relative strength,” says Ross Gittens ([Banking Regulation Can Work – We Are the Proof](#), *The Sydney Morning Herald*, 12 October) “there’s a valuable lesson it can learn from our success: sensibly done, government regulation of the financial markets can work a treat.”

Gittens continues: “Why is our banking system in such good shape, affected only indirectly by the global financial crisis? In a nutshell: because our central bankers, econocrats and politicians never fell for the extreme deregulatory, ‘efficient markets hypothesis,’ let-markets-have-their-heads-and-all-will-be-well nonsense the Yanks and Brits swallowed. You’d think these delusions were now thoroughly discredited. And in the minds of the world’s econocrats and politicians they no doubt are. In the minds of evidence-driven academics they probably are, too.”

Who, then, have we to blame for the turbulence of the past couple of years? Gittens accuses people whose “economic views are based on faith and political ideology rather than empirical evidence,” and who are “impervious to the destruction from the financial crisis they helped to cause. There are lots of rude names for them, but let’s call them libertarians ... It’s part of the libertarian creed that, since markets are without fault, all market malfunctions must have been caused by government intervention. QED. And so the libertarians of the world have embarked on a great quest to reinterpret reality to make it fit their theory, demonstrating the ‘government failure’ that caused the global financial crisis. We’re told it was a product of the error of the former U.S. Federal Reserve chairman, Alan Greenspan ... in holding short-term interest rates too low for too long. Or it was the fault of legislation sponsored by Jimmy Carter forcing banks to lend to poor people (talk about a slow fuse).” Gittens concludes: “Thank heavens our authorities were too sensible to swallow the dominant ideology [of libertarianism.]”

Australia didn't have is over."² *The Weekend Australian* (10-11 October) continued to blow its jingoist horn. "The Australian economy seems to know only one speed on its road to recovery: fast. After standing tall as one of the few developed economies to escape the ravages of recession induced by the historic financial crisis, the domestic economy has become a beacon of hope for global markets that the worst of the downturn as passed" (see also [World Can Learn a Lesson from Australia](#), *The Age*, 12 October). So all bow before the anointed central planners in Canberra! As *The Weekend Australian* (10-11 October) editorialised,

Australia is emerging from the global financial crisis earlier, faster and fitter than just about any other country. While we may never know the relative roles of the stimulus package, continuing demand for energy exports from China and the strength and stability of the financial system in saving us from a severe slump, there is no denying the government has done well ... [Accordingly,] it is time for the government to consider how to set up the economy for sustained growth when the crisis is gone for good.

In short, the Australian mainstream exults that, thanks to the Commonwealth's stimulus, the GFC's impact upon Australia is (as a "market economist" put it on 6 October) "almost if not completely over." I beg to differ. *Stimulus isn't an economic cause of recovery: it's a political consequence of the bust caused by poor economic policy.* A genuine bust eventually and inevitably follows the false boom. Fiscal and monetary interventionism delays, shortens, obfuscates and bastardises today's reckoning – at the cost of deepening and lengthening tomorrow's. The intermittent *panic* of 2007-2009, it is likely true, has abated. But if William White remains as perceptive today as he's been since the early 2000s, then the *recession and bear market* spawned by the Great Bubble probably hasn't concluded. Quite the contrary: thanks to governments' monetary and fiscal stimulus, it's barely started.

² This assertion is, to put it mildly, very doubtful. As Mike Steketee ([A Recession? It All Depends](#), *The Australian* 19 September) reminds us, "Whether during booms or downturns, governments for the past 40 years or more have been boasting that Australia was growing faster than the rest of the world. One reason for that, though rarely mentioned, is our rapid population growth fuelled by immigration. More people mean more demand for goods and services and more economic activity." Last year, net migration to Australia exceeded 250,000 souls – one of the highest figures on record and more than twice the annual rate during most of the past decade. Immigration accounted for most of last year's increase in Australia's population (1.2% of the 1.9%). For the past ten years, Australia's net immigration as a proportion of the population has run second only to Canada's. On top of that is the huge increase in temporary migration that saw more than 650,000 skilled workers, foreign students and visitors on working holidays come to Australia in the 2008-2009 financial year.

When comparing Australia's and other countries' rates of growth, Australia's heavy immigration stands this country's politicians in good stead. How to remove the effect of Australia's relatively high population growth upon mainstream measures of economic growth? By using per capita figures. "On this measure," as Steketee notes (bulls, avert your eyes!), "the national accounts tell us we have been in recession after all. On the more commonly used figure of seasonally adjusted GDP, the economy shrank only in the December quarter, thus avoiding the technical definition of recession of two consecutive quarters of negative growth. But in per capita terms the economy went backwards for the best part of a year. In each of the June and September quarters of last year, per capita GDP fell by 0.2 per cent and in the December quarter by another 1.2 per cent. This year, we struggled back to zero growth in the March quarter and a 0.1 per cent increase in the June quarter" (see also [Read the Data: It Was a Recession](#) by Steven Kates).

What I Have Long Believed and Continue to Believe: A Recapitulation

For a decade, Leithner & Company has marched to the beat of a non-mainstream drummer. It's precisely for that reason, I believe, that we've been able to generate reasonable results (for a summary, [click here](#)). "There are two requirements for success in Wall Street," Benjamin Graham told an interviewer a year before his death. "One, you have to think correctly; and secondly, you have to think independently." It's possible that we've been and remain well ahead of the times. Virtually from LCO's inception, and unlike virtually everybody else, we expected a severe recession and bear market. Although we couldn't predict *when* the reckoning would occur, we deduced roughly *what* would transpire. Because we had been expecting a "Global Financial Crisis," its arrival did not surprise us.

Although their details and emphases have differed, the themes of practically every Annual and Half-Year Report (and of most Leithner Letters, which are archived [here](#)) have been drearily monotonous. First, individuals, businesses and especially governments have long lived well beyond their means. Although the mainstream stridently denies it, saving and production – not borrowing and consumption – beget prosperity. You simply cannot borrow and consume your way (and the government cannot print its way) to plenty. Instead, savings, entrepreneurship and the accumulation of capital cause standards of living to improve. Greater amounts of more efficient capital render labour more productive; this, in turn, begets greater output per worker, which enables increased per capita consumption and leisure. Capital can accumulate only if adequate savings are available to finance it. And of course, one can save only by consuming less than one earns. Consumption is thus a consequence, not a cause, of prosperity.³ But for decades Australians have consumed more than they have produced. Accordingly, for years "the

³ One of the greatest fallacies of our gilded age is the exalted status of consumption relative to saving, investment and production. Mainstream economists relentlessly allege (and politicians and journalists dutifully parrot) that consumption is the engine of economic growth. They assert, in effect, that consumers do the world a favour by graciously consuming the goods that others produce. If consumers weren't so generous – that is, if a "deficiency of aggregate demand" occurred, then the unemployment of producers would result. Commentary often describes consumption as if it were hard work, "heavy lifting" or otherwise a meritorious and benevolent activity. Consumption, in short, allegedly creates demand for production.

This, of course, has things exactly back-to-front. The modern world no more depends upon consumption than medieval serfs depended upon the consumption of the lords who typically confiscated a quarter of serfs' production. Hence the mainstream ignores the *reductio ad absurdum*: what a disaster for the serfs if their lords had not exacted this tribute! Think of all the unemployment that serfs would have suffered had they not had to toil so hard for the "benefit" of their lords' consumption!

The truth is that, in both the medieval and modern worlds, the able-bodied man who consumes but does not produce is a parasite. In a free society you can demand only to the extent that you can supply; in other words, your ability to supply finances your *effective* demand. *Unfinanced* demand created by the central bank's relentless inflation, on the other hand – that is, the increase of the supply of money not backed by savings – is simply a drain on the productive efforts of some by the recipients of the paper.

fundamentals” of the Australian (and American, British, etc.) economy have NOT been sound. Quite the contrary: they have been precarious. A dodgy vehicle, particularly when its demented driver stridently insists that it’s safe, will eventually crash.

A second theme of our communications has emphasised that central banks’ monetary policies have long been as misguided as they are damaging. Central banks’ *raison d’être*, it seems, is to lower the rate of interest that they have commandeered (which in Australia is called the Overnight Cash rate, the rate at which banks borrow and lend bank reserves) well below the level that would prevail in a free market. Policy makers do their best to ensure, in other words, that interest rates cannot do their traditional job of harmonising and equilibrating the behaviour of borrowers and lenders. They create a wedge between borrowers and lenders by imposing upon them short-term rates that do not tell the truth about time and risk. As a result of a complex series of developments, mortgage and other rates have also fallen to artificially and dangerously low levels.

Why dangerously? Intervention in credit markets induces borrowers and lenders alike to commit egregious and painful mistakes (“malinvestments”). In particular, vast amounts of faux (because it’s not backed by genuine savings) and artificially-cheap credit have enabled people, businesses and governments to borrow much more and on far more lenient terms than they could in an unfettered market. This intervention has created a growing dependence upon debt, a “borrow now, repay later” mentality and the near-disappearance of the “save for a rainy day” ethos that served our forebears so well. The explosion of credit created from thin air rather than hard savings has inflated the prices of the things that people have used the funny-money to buy. Hence the third theme of our Annual and Half-Year reports, newsletters, etc.: thanks to poor public policy, dangerous bubbles have long existed – and today remain – in markets for stocks, bonds, and real estate.⁴

⁴ To appreciate central banks’ dereliction and recklessness, consider a rough analogy. The quantity of credit represents the “roads,” and the terms and conditions of loans (particularly rates of interest) are the “traffic lights,” of a market economy (or what passes for one in a régime of fiat money). To borrowers, interest rates signal when to go and when to stop; the quantity of credit determines where investors can travel; and its quality (that is, whether it’s backed by hard savings or thin air) determines the roadworthiness of the vehicles in which they travel.

Under the stimulus programs enacted after the implosion of the Dot Com Bubble, every borrower received keys (and a complimentary bottle of whiskey) to a **Trabant**, and every traffic light turned green. No light flashed red or even amber, and no traffic patrolman was in sight; accordingly, borrowers – following the crazed incentives and signs that governments erected – sped through economic and financial intersections. Neither borrowers nor lenders bothered to check actual road conditions. That they were effectively taking standard passenger vehicles off-road at high speeds and into uncharted territory seemed to bother nobody at all.

Speculators-Who-Thought-They-Were-Investors thus dug far more mines, built far more houses, shopping centres and office buildings, Darwin to Alice Springs Railways, etc., than they would (or could) have if central banks had not suppressed interest rates to multi-generational lows – and therefore if the quantity of credit were not growing and its quality not falling steeply. And so people borrowed far more – and paid higher prices for real estate, infrastructure, stocks and bonds – than their forebears would have considered prudent.

For decades, governments have pursued poor fiscal and monetary policies. These policies caused the GFC, and since mid-2007 they have become far worse. How have politicians and their advisers (who, remember, saw nothing whatsoever coming) reacted to a crisis caused by inflation⁵ and its consequences – too much consumption and borrowing relative to income and savings, artificially low rates of interest, resultant artificially high prices of stocks, bonds and real estate, and feeble saving? By vastly increasing governments’ indebtedness, suppressing rates of interest even further, urging individuals and businesses to borrow and spend themselves into even deeper holes, rewarding bankrupt but politically-powerful speculators and denigrating saving and frugality! How have they achieved these consequences? By escalating their cause: the central bank’s policy of relentless inflation (see also [The School of Salamanca Saw This Coming](#) by Jerzy Strzelecki). Further, by emphatically denying any responsibility for the crisis – indeed, by brazenly claiming that their “stimulus” has alleviated and will cure it – and by rescuing well-connected friends, rulers have broadened and deepened the dangers of “moral hazard.”

A crisis caused by government intervention has spurred vastly greater government intervention. This intervention, in turn, has stoked the fire of another crisis. Politicians and econocrats have moved heaven and earth to delay, shorten, obfuscate and bastardise today’s reckoning – at the cost of deepening and lengthening tomorrow’s. By pushing “real” (that is, net of CPI) interest rates below zero, central banks are distorting anew every investment decision. If mispriced debt helped to trigger Act I of the narrowly-averted destruction of global finance, then the “stimulus” enacted since mid-2007 has set the stage for Act II. In the meantime, ultra-low rates have reignited irrational exuberance in stock and bond markets. Yet regardless of the stimulus, the natural order of things remains. The boom, in other words, causes the bust; more generally, and try as they might, governments cannot abolish the laws of economics. Accordingly, debt will be purged one way or another; consumption will fall to a level commensurate with income; savings will be rebuilt, interest rates will rise and the prices of stocks, bonds and real estate will consequently fall.

Because it will eventually embrace us, we must accept rather than resist the bust. It’s hardly fun, but it’s necessary in order to address the real problem – poor public policy, particularly central banks and their policy of inflation. The inflation that

⁵ It is vital to emphasise: an increase in the prices of consumer goods and services as measured by the CPI is not a *definition* or *synonym* of inflation: it is *one of several possible consequences* of inflation. Others include bubbles in stock, bond and real estate markets, rising interest rates and (in extreme cases) collapses of the currency. Inflation, as Austrian School economists define it, is (stripped to its essentials) an increase in the supply of money not backed by a corresponding demand for money (i.e., savings). In an age of fiat money (that is, money whose definition is decreed by government rather than agreed in a free market, and whose regulation the state monopolises), only one entity can create inflation. No person or business or other private organisation (such as a glee club or trade union) can inflate the supply of money: only the central bank, using commercial banks as its agents, can. Martin Masse, a regular contributor to Canada’s *National Post*, is one of the very few people who both understands this point and writes for a general audience. See, for example, his superb [Milton Friedman: The Monetary Statist](#) (8 September 2009).

ignites the boom sends false signals to markets, namely that there exist sufficient savings to support higher levels of investment. Because no actual increase of savings occurs (indeed, during the Great Bubble the propensity to save fell drastically) these higher levels of investment are unfunded and the higher profits they generate are unsustainable. Like the razing of a house built upon a rickety foundation, the liquidation of “malinvestments” in capital, land and labour is a necessary precursor of sound reconstruction. A sound economic expansion, which is financed by genuine savings, does not beget a bust. Only the inflation-induced variety ignited by central banks sows the seeds of its own destruction.

These insights fly in the face of the modern thinking that regards the business cycle as the inevitable result of some inherent flaw in capitalism. This thinking mistakenly believes that the government can mitigate or even prevent recessions, and never sees that intervention in markets by governments is the source of economic and financial instability. *Cycles of boom and bust, we have said repeatedly for a decade, are NOT inevitable and are NOT inherent in the free market economy. Without the inflationary monetary policies of the central bank – which is a creature of the state and not the free market – cycles of boom and bust would not occur.* Mainstream economists regard the alleged “overinvestment” that occurs during booms as mistakes made by businesses, but they rarely ask why these mistakes were committed. During the boom, businesses do not recklessly “overinvest;” instead, they respond to the false signals emitted and created by the central bank.

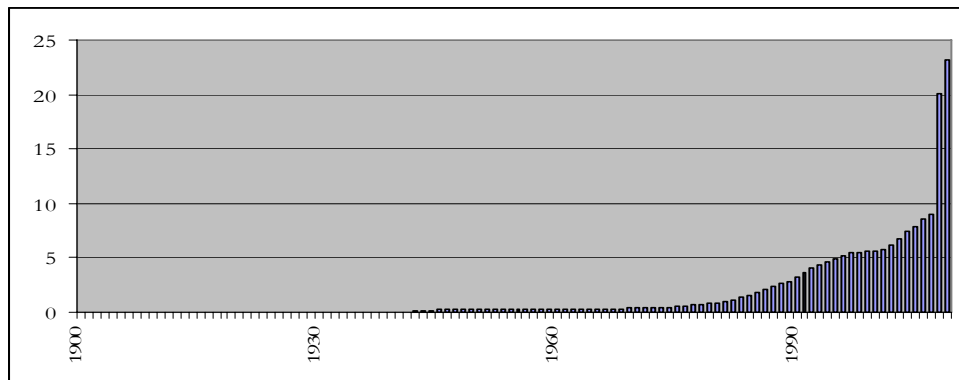
Let us therefore hope that there will be no recovery – at least in the sense that the crowd and its rulers crave it. The mainstream does not yearn for genuine financial and economic health – that is, an economy where the savings and entrepreneurship generated in a free market underwrite the production that finances prosperity. Nor do they want a financial sector which dispenses credit according to character and thereby prices risk cautiously. The crowd and government desire a return to the *status quo ex ante*. They demand, in other words, the modern equivalent of bread and circuses: a debt-financed orgy and consequent series of asset bubbles. They desire the boom, but deny that the bust is its conjoined twin.

Our Enemy, the State

Alas, the risk is growing that such a “recovery” will, at least for a time, occur. Since mid-2007, central banks’ balance sheets (and hence the potential supply of money) have expanded at unprecedented speeds. Similarly, if we take politicians’ intention to borrow at face value, then during the next decade the supply of government bonds will grow at a pace that exceeds anything ever seen. On 6 October, for example, the U.S. Treasury floated its largest-ever issue of 3-year bonds (\$39 billion, if you please, surpassing the previous record of \$32 billion set in late August). The 3-year notes were a small part of a total \$162 billion of new U.S. Government debt sold during the week of 5-9 October. I doubt that individuals and corporations will be indefinitely willing and able to absorb such a vastly increased supply at today’s prices. That means central banks and treasuries will increasingly do so; and that, in turn, means even more inflation.

In a statist world, perceptions about sovereign creditworthiness calibrate the world's economic and financial thermostat. For decades the conviction has been wide, deep and seemingly impregnable: U.S. Treasury securities are the planet's safest credit risk. The yield of a Treasury bill has been the benchmark (or "risk-free") rate of return; and other assets (ranging from American corporate bonds to European stocks to New Zealand real estate) are priced, if only indirectly, relative to its yield. In recent years, the yields of Treasury bills and bonds have stood at or near historical lows. From the mid-1990s to mid-2000s, these ultra-low yields helped to spawn what by venerable standards were very high – and, in retrospect, dangerously high – asset prices. But what if (as I have long maintained) these yields remain far lower than they ought to be? What if, ironically, the "risk-free" rate is actually fraught with risk (one wag has noted that the alleged "risk-free return" of Treasury securities is more accurately described as "return-free risk"), and Uncle Sam's sovereign credit rating vastly overstates his creditworthiness? If so, then a disturbing possibility presents itself: in the not-too-distant future this rating will be downgraded – conceivably to "junk" levels.⁶

Figure 11:
America's "On Balance Sheet" National Debt (Trillions of \$US)



⁶ Figure 11 shows the U.S. Government's "on balance sheet" liabilities – that is, those appearing in its financial statements in some form or another. They comprise the national debt of ca. \$11.2 trillion accumulated since 1789 and the bailouts, stimulus packages etc., of \$11.6 trillion enacted since mid-2007. Adding "off balance sheet" obligations (i.e., Medicare, Social Security and other expenses that will be incurred in the years to come), the present value of U.S. governments' total net liabilities is ca. \$80 trillion. Either massive increases of tax will be required in order to service – or draconian cuts of benefits will be necessary in order to reduce – these obligations. Or else a wave of inflation is in store (see also [Is the United States Bankrupt?](#) by Laurence Kotlikoff).

In a research report released on 22 March 2005 – that is, more than two years before the eruption of the GFC – and entitled *In The Long Run, We Are All Debt: Aging Societies and Sovereign Ratings*, Standard & Poor's concluded that unless they move quickly and forcefully to balance their budgets and reduce their spending, spiralling pension and medical expenditures will within 30 years reduce the debt of the world's richest industrialised countries to "junk" status. If current policies remain unchanged (since 2005, of course, they've become far more profligate) then the sovereign debt of France, presently rated AAA (the highest possible rating) will become "junk" (i.e., plummet to a sub-investment grade of BBB minus or less) by the early 2020s; that of the U.S. and Germany will do so before 2030 and the UK will follow by 2035. For details, see *The Intelligent Australian Investor* (John Wiley & Sons, 2005, chap. 4) and [Avoid the Rush](#) by Chris Leithner. And *Barron's* (28 September 2009) adds that a sovereign default by Japan "is not only possible but likely, experts say. Can that once-thriving nation be saved?"

In most Western countries, individuals and businesses are responding to signals that governments are trying to muffle or reverse, i.e., they are curbing their appetite for new debt and hastening the repayment of old debt. After ca. 60 years of growth, credit is now shrinking – in the private sector. (Australia is an exception. At the end of July 2009, its banks' loan portfolios totalled \$1.62 trillion. That compares to \$1.47 trillion in July 2008 and \$1.22 trillion in July 2007.) Alas, rulers' profligacy is offsetting subjects' prudence. The Flow of Funds reports issued quarterly by the Federal Reserve show that since mid-2007 households and businesses have been reducing their indebtedness at an annualised rate of ca. 2.5%. Although it must do much more, America's private sector is slowly restoring its finances to order.⁷

In contrast, government in general and the U.S. Government in particular are running ever more wildly amok. Since mid-2007 Washington's debt has exploded by 30% per annum. Its budget deficit will total \$1.5 trillion this year (and also \$1.5 trillion for 2010), and the Congressional Budget Office forecasts that during the next 10 years shortfalls will total \$9.5 trillion (since mid-2007, its revisions have been uniformly upwards). If so, then "on balance sheet" national debt (including the various "stimulus" boondoggles) would exceed \$US32 trillion. Federal debt in the U.S. equaled 61.4% of GDP in 1999, grew to 70.2% in 2008, will climb to an estimated 90.5% this year and touch 100% in 2011 – after which it will exceed the nation's entire annual economic output by ever greater margins. The U.S. is thus poised to enter the ranks of those nations – Italy, Jamaica, Japan, Lebanon and Zimbabwe – with the highest ratios of government debt to GDP. In 2008, it ranked 23rd on this list, and crossing the 100% threshold vaults it into seventh place. Clearly, America's (and Britain's, etc.) fiscal and monetary chaos is not merely increasing: it is accelerating.

Uncle Sam's worsening economic and financial condition is taking its toll on the \$US. If the Greenback continues its secular swoon, the world may at some point face a reserve currency crisis. How to arrest the fall of the \$US? Stop printing so many of them. How to do that? Stop issuing so many government bonds. How to do that? Slash today's spending by two-thirds. (Is that extreme? It means balancing the U.S. Government's budget at a level which prevailed during the first Clinton administration. What are extreme are the fiscal and monetary policies of the past decade.) The need to act is being delayed because, for now, the fall in the \$US is boosting the nominal prices of stocks, bonds and commodities. But I doubt this can continue indefinitely. At some point, the truth will dawn: a relent-

⁷ Let's assume that the total burden of private sector debt in the U.S. will recede to less than 200% of GDP – a level that prevailed for most of the second half of the 20th century. If so, then households and businesses must eliminate debt equal to ca. 160% of GDP, i.e., a mere \$20 trillion. How does one eliminate debt? Some of it simply disappears through defaults, foreclosures and bankruptcies. The rest is repaid through saving. Now (even more optimistically) imagine that Americans henceforth devote an amount equal to 15% of GDP to the repayment of debt. That's savings and capital formation of all types – corporate as well as individual. Under these very optimistic premises, the reduction of America's private debt to less than two times annual output implies a seven-year diet. Clearly, we should prepare for a long drought: historically, in the best of cases the American public has been obliged to ride the wagon of frugality for 7-14 years.

lessly falling \$US and gold that continues to rise beyond \$US1,000 per ounce means that inflation has become intractable. Even *The Wall Street Journal* is nervous. On 17 September it summarised matters thus:

- Q: OK, Ben Bernanke put out the financial fires that threatened to burn down the economy. What are his biggest challenges now?
- A: One, pick the right time to raise interest rates from today's near-zero level and drain the massive amounts of credit the Fed has pumped into the economy. Act too soon, and he risks provoking another recession. Act too late, and he gets more inflation than he deems prudent.
- Q: Given all the [credit] that the Fed has creates, isn't inflation inevitable?
- A: ... Having created so much credit, the Fed is taking a big risk that it will get more inflation than it wants. Some observers, citing historical precedent, say an outbreak of inflation is inevitable. Inflation can be avoided only if the Bernanke Fed has the forecasting skill and luck to withdraw credit soon enough, and has the political fortitude before everyone is convinced that the economy is back to something resembling normal.
- Q: If the Fed helped to get us into this mess, why put it in charge of preventing the next crisis?
- A: If the problem is inherent in the Fed ... then it is destined to repeat the errors of the past.
- Q: Are we just supposed to ignore the trillions of dollars of government debt?
- A: The US Government has demonstrated that it can borrow seemingly limitless amounts at low interest rates ... But someday, foreign investors will be sated or demand higher interest rates, and the US economy will suffer.

Out With Panic, In With the Recession and Bear Market

So I'm ignoring all the talk that "the worst has passed," "green shoots" are sprouting, "recovery" is nigh, etc. America's (and Britain's, etc.) rulers are trashing their countries' financial position ever more aggressively. The Bush and Obama administrations, for example (which are simply separate wings of a single bird of prey, and whose underlying economic policies are indistinguishable), have subsumed overleveraged consumer and financial sectors under Uncle Sam's much more overleveraged balance sheet. For the moment this has blunted and delayed – but as the indebtedness builds it will eventually intensify – the pain of deleveraging. Reckless actions usually have damaging consequences, and the results of governments' fiscal and monetary recklessness include rising prices, taxes and unemployment, and a longer than anticipated (or "double-dip") recession.⁸

Alan Greenspan spies these consequences but denies that his or his successor's policies have caused them. (Indeed, on 1 October he praised the steps taken by Ben Bernanke "to help pull the economy out of recession. The Fed has done a

⁸ Carmen Reinhart and Kenneth Rogoff ("The Aftermath of Financial Crises," NBER Working Paper No. 14656, January 2009) conclude their analysis of data extending back more than a century that post-crisis downturns tend to be "protracted affairs." So do Barry Eichengreen and Kevin O'Rourke ("A Tale of Two Depressions"), who show that in economic and financial terms the years 1929-1931 provide the closest parallel to 2007-2009.

splendid job.”) Still, he avers, credit conditions must tighten and taxes must rise. Also, the Fed must siphon from the financial system much of the credit it has “injected” since mid-2007. “My concern,” said the Great Inflator and Great Evader, “is that legislation or other actions on the part of Congress may prevent” the Fed’s withdrawal of stimulus. “Unless we sterilise or unwind the big monetary base we’ve built up, two, three years out [the consequences of inflation] really begin to take hold.” Further, although he praised President Obama, he doesn’t “think he is sufficiently in control of a very serious budget problem.”

Prices, taxes, etc., may not begin to rise tomorrow; but once they do their momentum will be very hard to stop. Downplayed in America, Britain, Europe and Japan (and virtually ignored in analyses and debates about Australia’s “stimulus”) is an immutable fact: even under rosy scenarios in most countries including Australia, public sector debt will henceforth rise, perhaps sharply, as a percentage of GDP. Whenever the rate of interest payable on the government’s debt exceeds the economy’s rate of growth, the debt-to-GDP ratio (i.e., the government’s “leverage” or “gearing”) grows. As an illustration, assume that Australia’s GDP is \$100 and that during a given year it grows by 1% to \$101. (According to the International Monetary Fund’s latest forecasts, Australia’s nominal GDP will grow 0.7% in 2009.) Also assume that at the start of the year the sum of Commonwealth and state debt is 15% of GDP (which approximates the present figure), and that its bonds pay an average of 5.5% interest (ditto). Total interest payable at the end of the year is thus $\$15 \cdot 0.055 = \0.825 . In order to pay it, Commonwealth and state governments must either run budget surpluses of this amount (or, equivalently, cut their expenditure during the year by this amount), or borrow it. If they borrow it, then at the beginning of the next year debt increases to \$15.825 and the debt-to-GDP ratio rises to $\$15.825/\$101 = 15.7\%$.

The risk is that long-term rates of interest will rise, thereby placing further upward pressure upon the debt-to-GDP ratio. The funds that governments are borrowing to finance their huge and growing budget deficits cannot finance the replacement and accumulation of private capital. The more that governments borrow, the more they “crowd out” private investment and thereby ensure that the nation’s stock of private capital will be lower than it otherwise would be. Unless the state’s “investments” earn higher returns than those that individuals and businesses would have earned with the funds the government borrowed, they siphon activity from more productive towards less productive ends, and thereby reduce national income below the level that would otherwise have prevailed. When the state borrows, the pool of funds available for investment in the private sector shrinks. The competition for these remaining funds tends to increase lenders’ hand relative to borrowers’ – i.e., to stiffen loans’ terms and conditions, and to increase their rates of interest.

Rates of interest will also rise if lenders expect that the CPI’s rate of increase on a worldwide basis (the Cleveland branch of the Fed produces such an index) will accelerate. This is especially likely to happen if the Fed, Bank of England, etc., continue to do what (to greater or lesser extents) they have done over the past

year: purchase (“monetise”) public debt with money created, in effect, out of thin air. The staggering amounts of funny-money that have already been pumped into markets by central banks as part of their monetary “stimulus,” together with the additional titanic amounts they must pump in order to finance governments’ current and coming budget deficits, will, I fear, eventually place strong upward pressure upon the CPI. This occurred around the world after the fiscal and monetary excesses of the 1960s and 1970s, and produced prolonged “stagflation” – that is, a combination of stagnation and inflation.

Having canvassed these grim scenarios, let’s for a moment be optimistic and imagine that within a year the rate growth of Australia’s GDP increases to ca. 3% in real terms and the rate of increase of CPI decelerates to ca. 2% per annum. Even under rosy scenarios, as long as the Commonwealth and states collectively run budget deficits the ratio of public debt to GDP will continue to grow. And if long-term interest rates rise, this ratio will be even harder to stabilise – never mind reduce. Given the profligate policies of American, British, European and Japanese governments, higher interest rates seem very likely, and the more that rates rise the more aggressively the public debt-to-GDP ratio will feed upon itself, and eventually require draconian reactions to bring it under control. Yes, the ratio of government debt to GDP in Australia is relatively low by international standards. But on a per capita basis Australia is one of the world’s heaviest borrowers in international markets. Coupled with the fact that the Commonwealth’s fiscal turnaround (that is, from big surplus to big deficit) has been one of the Western world’s most sizeable in terms of GDP, Australia is very vulnerable.

Ross Garnaut agrees. An architect and major public proponent of the economic and financial reforms of the 1980s, Garnaut has just published (with David Llewellyn-Smith) *The Great Crash of 2008*. He warns that since mid-2007 spats between politicians have distracted attention from “substantive issues.” The e-mail episode involving a Treasury official in charge of the OzCar boondoggle, for example, obscured “the danger of using huge amounts of public money to bail out private companies at the direction of bureaucrats.” Stimulus all ‘round has created “an environment that encourages rent-seeking behaviour in the corporate sector and soft responses from government. It becomes the basis for sympathetic consideration for all manner of subsidies” and “a generalised justification for increased government intervention in the economy.” Garnaut warns that the pre-crisis boom of housing and consumption, financed mostly from overseas, has not unwound – but will. As a result, “there are hard times ahead. Sustainable full employment will require reduction of average incomes and living standards below those to which Australians became accustomed before the crash. The Australian government, community and business leadership has barely begun to contemplate the adjustment that is required.”⁹

⁹ Garnaut is the first (to my knowledge) impeccably-mainstream source who has admitted the truth: during the worst of the panic (namely from mid-September to mid-December 2008) the Australian banking system was “insolvent” (see [ABA Disputes Garnaut Claim of Insolvency](#), *The Australian* 14 October). Actually, Garnaut is close but not quite right: by their very nature, modern banks, which are fractional reserve banks, are always insolvent. Crises merely provide opportunities to the general

“Massive government borrowing programs threaten to choke a still-fragile global economic recovery by pushing interest rates higher and reducing available credit for the private sector.” So warned the International Monetary Fund in its latest (30 September) review of what it politely (and apparently with a straight face) describes as “global financial stability.” Further, although the panic of a year ago has abated, the IMF cautions that the world’s banks are still facing huge bad debts that could yet cause a “double-dip” global recession. The good news is that the IMF lowered its estimate of the total bank write-downs and losses stemming from the GFC from ca. \$US4 trillion to roughly \$US3.4 trillion. The bad news is that less than half of this total loss has thus far been realised, and that the pace of losses is set to rise as unemployment, delinquencies and defaults continue to mount. IMF also frets that, at a time when governments’ voracious borrowing is commandeering so much savings and creating so much artificial credit, weakened banks, which must purge another ca. \$US1.5 trillion of bad debts from their balance sheets, will be unable to provide business and households with the huge quantity and low prices of credit they’ve come to expect. “Since all credit providers can buy sovereign debt, sovereign issuance will effectively compete with – and possibly crowd out – private sector credit needs.”

The IMF’s concerns echo the comments that Glenn Stevens – once in a while he does get something right – uttered a few days before. “The thing which is most likely to crowd out Australian businesses and other businesses by pushing up the long-term global interest rate,” he said, “is not going to be the Australian government’s contribution to borrowing, unless it is a lot bigger than it looks like being – it will be the huge run-up in public debt in the major countries, which are quantitatively so much larger.” In the five years before the collapse of the Great Bubble, borrowing in major “advanced” (i.e., deadbeat) countries averaged \$US1 trillion per year. It doubled in 2008, will reach \$US3.2 trillion this year and allegedly fall to \$US2.2 trillion in 2010. The IMF said that over the next two years, the total borrowing needs of government and the private sector will (by amounts ranging from 2.4% of GDP in the U.S., 3% in Europe and 15% in the Old Country) exceed the ability of the finance sector to supply funds.

It’s not *despite* the continuing depressed and indebted state of these economies, as the IMF says, but *because of it*, that the pressure upon long-term rates is upwards. “There’s no question that the most significant vulnerability as [the world emerges] from recession [sic] is the soaring government debt,” Harvard University economist Kenneth Rogoff told Bloomberg on 24 September. “It’s very likely that will trigger the next crisis as governments have been stretched so wide.” Bloomberg added that even a deceleration of the rate of increase of borrowing “will probably require leaders to raise taxes and cut spending, ushering in an ‘age of austerity’ that saps growth prospects for years to come.”

public to see behind the veil and, like Dorothy beholding the Wizard of Oz, understand at last that it’s a fraud from top to bottom (Murray Rothbard, [Fractional Reserve Banking](#) (*The Freeman*, October 1995 and [Leithner Letter 102-104](#)).

Hence I remain very bearish about the future. The excesses caused by decades of poor policies, which have culminated in the “stimulus” policies enacted since 2007, cannot be purged within a few quarters. Entrepreneurs cannot build a firm recovery upon the rubble of a collapsed bubble. It will take years to realign debt and the capacity of individuals, businesses and governments to service it. During this lengthy and painful process, many people will belatedly realise that they do not own debt-financed “assets” such as houses; instead, they will at last understand that their debt owns them. I expect that that next decade will resemble the 1970s more than the 1930s or the 1990s. It may well include an extended period of stagnation or recession and falling asset prices, together with rising consumer prices and rates of interest (“stagflation”). The results of the poor (i.e., interventionist) policies of the past have finally returned to the roost, and the growing clamour for yet more intervention will merely strengthen the downdraught.

Some General Scenarios for the Next Decade

How can we inform sensible expectations about the future? One way is to set our dour outlook to one side and examine average investment results over varying periods of time. Assume that your portfolio perfectly mirrors the S&P 500 Index. What return can you expect it to earn over periods of one, five, ten and 20 years? Of the average return, what portion comes from increases in the prices of stocks and what portion from dividends? And what has been the impact upon returns of the virtually uninterrupted rise of the Consumer Price Index?

Table 1:
Returns (Compound pa), Standard & Poor’s Index, January 1871-June 2009

| | Unadjusted for CPI | | | Adjusted for CPI | | |
|-------------------|--------------------------|---------------------------|------------------------|-----------------------|------------------------|---------------------|
| | Capital Return (Nominal) | Dividend Return (Nominal) | Total Return (Nominal) | Capital Return (Real) | Dividend Return (Real) | Total Return (Real) |
| All 1-Yr Periods | 4.52% | 5.49% | 10.01% | 3.15% | 4.62% | 7.78% |
| All 5-Yr Periods | 4.44% | 4.79% | 9.23% | 2.27% | 4.74% | 7.01% |
| All 10-Yr Periods | 4.51% | 4.81% | 9.32% | 2.23% | 4.71% | 6.94% |
| All 20-Yr Periods | 4.47% | 4.88% | 9.35% | 1.99% | 4.77% | 6.76% |
| Jan 1871-Jun 2009 | 3.93% | 4.79% | 8.72% | 1.88% | 4.63% | 6.51% |

Table 1 answers these questions.¹⁰ It summarises all of the 1,650 12-month intervals between January 1871 and June 2009 (i.e., January 1871-January 1872, Febru-

¹⁰ I have reanalysed the dataset compiled by Robert Shiller for his book *Irrational Exuberance* (Princeton University Press, 2000 and subsequent editions). Updated monthly, it contains a wealth of data about the S&P 500. No comparable Australian data are publicly available; hence we must cross our fingers and assume that these American results apply to Oz.

ary 1872-February 1873, ... and June 2008-June 2009), all possible five-year results, etc. It defines total investment return as the sum of two components: capital appreciation and dividend. It expresses total investment return and its components in “nominal terms” (i.e., ignoring the Consumer Price Index) and in “real” terms (that is, net of the CPI). They show that compound total returns of 8.5-10.0% per annum (in nominal terms) and 6.5-7.5% per annum (in real terms) are the norm.

Table 1 confirms a tenet of sound investing: *the longer is the time horizon, the more important is the dividend's contribution to the total return.* The present value of a portfolio reflects the present value of the stream of dividends it emits. In contrast, the present value of (eventual) capital appreciation dwindles over time. To see this, look down the two “capital return” columns and observe that the percentages decrease as the investment horizon lengthens. In contrast, the figures in the dividend return columns remain remarkably stable. As a result, the dividend return relative to total return rises as the investment horizon expands. On average over all one-year periods, real dividends comprise $4.62 \div 7.78 = 59\%$ of the total real return. Over all five-year and ten-year intervals, dividends comprise 68% of the total return, and over all 20-year periods they contribute 71%.

It's no surprise that nominal returns exceed real returns. What might surprise market participants – I hope it shocks them – is that the CPI (whose annual increase has averaged 2.2% since 1871) is equivalent to a flat tax of $2.23 \div 8.72 = 25\%$ upon returns. In particular, *CPI harms returns by reducing capital returns; but it does not, by and large, harm the value of dividends.* To see this, compare capital returns within each row. Over one-year periods, the average capital return is 5.21% (unadjusted) and 3.15% (adjusted); over five-year periods, it is 4.44% (unadjusted) and 2.27% (adjusted), etc. Over all time horizons, adjusted capital gains are significantly lower than unadjusted capital gains. Over one-year periods, the average dividend return is 4.49% (unadjusted) and 4.62% (adjusted); over five-year periods, the average is 4.79% (unadjusted) and 4.74% (adjusted), etc. Over all time horizons, adjusted dividend returns are not significantly lower than their unadjusted counterparts. *The more one's total investment return derives from dividends, in other words, the less the CPI will trash it over time.*

What about the variability of returns? Let's record each one-year total return and its components in both nominal and real terms; sort this array of 12-month returns from highest to lowest according to the total real return; divide this sorted list into “quintiles,” i.e., five groups which each contain an equal number of observations; and finally, within each quintile, compute the mean of each type of investment return.¹¹ The results of this exercise appear in Table 2. Results of similar exercises using five-year and ten-year returns appear in Tables 3-4.

¹¹ For further details of this method, which has a rather long history in financial analysis, see Francis Nicholson, “Price-Earnings Ratios in Relation to Investment Results,” *Financial Analysts Journal* (January-February 1968); David Dreman, *Contrarian Investment Strategies: The Next Generation* (Simon & Schuster, 1998), and James P. O'Shaughnessy, *What Works on Wall Street* (McGraw-Hill, 1998).

**Table 2:
The Variability of One-Year Returns,
Standard & Poor's Index, January 1871-June 2009**

| | Unadjusted for CPI | | | Adjusted for CPI | | |
|------------|--------------------------|---------------------------|------------------------|-----------------------|------------------------|---------------------|
| | Capital Return (Nominal) | Dividend Return (Nominal) | Total Return (Nominal) | Capital Return (Real) | Dividend Return (Real) | Total Return (Real) |
| Quintile A | 28.09% | 5.59% | 33.67% | 27.27% | 5.56% | 32.83% |
| Quintile B | 14.03% | 5.43% | 19.46% | 11.92% | 5.37% | 17.28% |
| Quintile C | 3.43% | 4.48% | 7.91% | 2.61% | 4.48% | 7.09% |
| Quintile D | -3.05% | 4.60% | 1.55% | -6.75% | 3.96% | -2.79% |
| Quintile E | -19.86% | 3.74% | -16.12% | -22.91% | 3.60% | -19.31% |

Table 2 shows that, in both nominal and real terms, total one-year returns vary drastically from year to year. There's a one-in-five chance of a total gain of more than 30% (Quintile A); but there's also a one-in-five chance of a total loss of more than 15%. Indeed, in real terms, there's a 40% chance (Quintiles D and E) that in any given 12-month interval a loss will be incurred. Total returns (real and nominal) are variable because capital returns (real and nominal) are variable. In nominal terms, they vary 49.8 percentage points from the highest to the lowest quintiles, and in real terms they vary 52.1% percentage points. In sharp contrast, dividend returns are remarkably constant. Whether the total return is excellent (Quintile A) or abysmal (Quintile E), dividend returns vary by less than two percentage points. *Clearly, the greater the dividend as a percentage of one's total return, the more stable – and positive – that return will be.*

**Table 3:
The Variability of Five-Year Returns (Compound pa),
Standard & Poor's Index, January 1871-June 2009**

| | Unadjusted for CPI | | | Adjusted for CPI | | |
|------------|--------------------------|---------------------------|------------------------|-----------------------|------------------------|---------------------|
| | Capital Return (Nominal) | Dividend Return (Nominal) | Total Return (Nominal) | Capital Return (Real) | Dividend Return (Real) | Total Return (Real) |
| Quintile A | 13.85% | 5.30% | 19.15% | 12.53% | 5.48% | 18.01% |
| Quintile B | 7.61% | 4.90% | 12.52% | 5.95% | 4.84% | 10.79% |
| Quintile C | 4.15% | 4.57% | 8.71% | 2.47% | 4.51% | 6.98% |
| Quintile D | 0.19% | 4.96% | 5.14% | -2.26% | 4.82% | 2.57% |
| Quintile E | -4.61% | 4.17% | -0.44% | -8.52% | 3.98% | -4.54% |

Tables 3-4 show that these results also apply over five- and ten-year intervals. The longer the interval, the less is the fluctuation of the total return. Yet in both nominal and real terms, total five-year returns continue to vary considerably. In any random-selected five-year interval there's a one-in-five chance of a total gain of more than 15% (Quintile A) – and also a one-in-five chance of a loss (Quintile E). *Indeed, in real terms there's a 20% chance of a loss over periods of five and ten years.* The once-unshakeable belief that stocks become virtually riskless over the “long

term,” popularised by books like Jeremy Siegel’s *Stocks for the Long Run* (McGraw-Hill, 2002) and James Glassman and Kevin Hassett’s *Dow 36,000: The New Strategy for Profiting From the Coming Rise in the Stock Market* (Three Rivers Press, 2000) and which recent events have shown is highly questionable, never was true.

Table 4:
The Variability of Ten-Year Returns (Compound pa),
Standard & Poor’s Index, January 1871-June 2009

| | Unadjusted for CPI | | | Adjusted for CPI | | |
|------------|--------------------------|---------------------------|------------------------|-----------------------|------------------------|---------------------|
| | Capital Return (Nominal) | Dividend Return (Nominal) | Total Return (Nominal) | Capital Return (Real) | Dividend Return (Real) | Total Return (Real) |
| Quintile A | 10.85% | 5.08% | 15.92% | 8.86% | 5.00% | 13.85% |
| Quintile B | 6.06% | 4.87% | 10.94% | 4.95% | 4.85% | 9.80% |
| Quintile C | 3.88% | 4.64% | 8.52% | 2.31% | 4.58% | 6.89% |
| Quintile D | 1.56% | 4.81% | 6.36% | -0.72% | 4.69% | 3.98% |
| Quintile E | -0.79% | 4.61% | 3.82% | -5.73% | 4.38% | -1.35% |

Table 5:
One-Year Returns Stratified by CPI
Standard & Poor’s Index, January 1871-June 2009

| | Unadjusted for CPI | | | Adjusted for CPI | | |
|-----------------|--------------------------|---------------------------|------------------------|-----------------------|------------------------|---------------------|
| | Capital Return (Nominal) | Dividend Return (Nominal) | Total Return (Nominal) | Capital Return (Real) | Dividend Return (Real) | Total Return (Real) |
| Mean CPI 10.66% | 2.88% | 5.20% | 8.08% | -6.88% | 4.69% | -2.19% |
| Mean CPI 3.66% | 7.85% | 4.22% | 12.07% | 4.29% | 3.62% | 7.91% |
| Mean CPI 2.10% | 16.48% | 4.21% | 20.70% | 14.11% | 4.13% | 18.23% |
| Mean CPI -0.05% | 2.50% | 4.90% | 7.40% | 2.61% | 4.91% | 7.52% |
| Mean CPI -6.73% | -5.38% | 5.54% | 0.16% | 1.37% | 5.97% | 7.34% |

Total returns (real and nominal) in the medium and long term fluctuate because capital returns (real and nominal) fluctuate. They do so less in Table 3 than in Table 2 (and less in Table 4 than in Table 3), but they continue to vary far more than dividend returns. In nominal terms, capital returns vary by 18.5 percentage points from the highest to the lowest quintiles, and in real terms they vary 21.0 percentage points. In contrast, returns from dividends remain remarkably constant: indeed, they are more constant in Table 3 than in Table 2 (and more constant in Table 4 than in Table 3). Whether the total return is excellent (Quintile A) or abysmal (Quintile E), dividend returns vary by ca. 1.5 percentage points in Table 3 and by less than one percentage point in Table 4.

We can say more about the CPI's impact upon investment results. Let us sort the array of one-year investment returns from highest to lowest according to the rate of change of the CPI; divide this sorted array into quintiles; and finally, within each quintile, compute the mean of each type of investment return. The results of this exercise appear in Table 5. Results of similar exercises using five-year and ten-year returns appear in Tables 6-7.

**Table 6:
Five-Year Returns (Compound pa) Stratified by CPI
Standard & Poor's Index, January 1871-June 2009**

| | Unadjusted for CPI | | | Adjusted for CPI | | |
|--------------------|--------------------------|---------------------------|------------------------|-----------------------|------------------------|---------------------|
| | Capital Return (Nominal) | Dividend Return (Nominal) | Total Return (Nominal) | Capital Return (Real) | Dividend Return (Real) | Total Return (Real) |
| Mean CPI 7.47% pa | 3.31% | 5.27% | 8.58% | -3.80% | 4.90% | 1.10% |
| Mean CPI 3.64% pa | 7.47% | 4.08% | 11.55% | 3.70% | 3.93% | 7.63% |
| Mean CPI 2.24% pa | 6.48% | 3.96% | 10.44% | 4.16% | 3.87% | 8.03% |
| Mean CPI 0.48% pa | 7.77% | 5.19% | 12.96% | 7.26% | 5.37% | 12.63% |
| Mean CPI -3.52% pa | -3.45% | 5.52% | 2.07% | 0.04% | 5.73% | 5.77% |

**Table 7:
Ten-Year Returns (Compound pa) Stratified by CPI
Standard & Poor's Index, January 1871-June 2009**

| | Unadjusted for CPI | | | Adjusted for CPI | | |
|--------------------|--------------------------|---------------------------|------------------------|-----------------------|------------------------|---------------------|
| | Capital Return (Nominal) | Dividend Return (Nominal) | Total Return (Nominal) | Capital Return (Real) | Dividend Return (Real) | Total Return (Real) |
| Mean CPI 6.51% pa | 2.75% | 5.78% | 8.53% | -2.38% | 5.49% | 3.11% |
| Mean CPI 3.82% pa | 7.86% | 4.44% | 12.30% | 3.93% | 4.25% | 8.18% |
| Mean CPI 2.43% pa | 6.01% | 3.94% | 9.95% | 3.49% | 3.85% | 7.34% |
| Mean CPI 0.58% pa | 5.44% | 4.90% | 10.34% | 4.83% | 4.88% | 9.71% |
| Mean CPI -2.47% pa | -0.49% | 5.45% | 4.96% | 2.06% | 5.58% | 7.64% |

Periods when the CPI is “low” (which the mainstream defines as an increase of ca. 2% per year) are most conducive to strong investment returns. Conversely, periods when CPI either rises or falls rapidly (Quintiles A and E) are least favourable to strong returns and most likely to produce capital losses. The 12-month periods in Quintile C, during which the CPI increased an average of 2.1%,

show average nominal returns of 20.7% and average real returns of 18.2%. Also, notice that capital growth provides the bulk (80% in nominal terms and 77% in real terms) of these returns. Quintiles B and D, in which CPI increased an average of 3.66% and declined an average of 0.05%, respectively, also provide good nominal and real returns; in these quintiles, however, dividends comprise ca. two-thirds of the total nominal and real return.

Investors beware: years when the CPI soars are years when investors suffer losses. In Quintile A of Table 5, which comprises that 20% of 12-month periods when CPI rose most rapidly (by an average of 10.66%), stocks increased an average of 2.88% in nominal terms but fell 6.88% in real terms. Although dividends rose 4.69% in real terms, the loss of capital was enough to incur an overall loss of 2.19% in real terms. Spurred by extremely strong capital growth, the heftiest returns tend to occur in years when the CPI rises by ca. 0.5-3.5%, and losses arise when CPI exceeds this threshold. More generally, stable consumer and producer prices beget strong rises of the prices of stocks; monetary disturbances, on the other hand, which cause the level of consumer prices either to rise or fall appreciably, are associated with a stagnation and decrease of stock prices. In contrast, regardless of the rate of change of CPI, the return from dividends (nominal and real) is remarkably constant.

Some Specifically Bearish Scenarios for the Future

Let's now return to our bearish outlook. What do past recessions and bear markets tell us about what the present recession and bear market (which is how I characterise the present, even though practically nobody else does) might hold in store? Figure 12 depicts four of the most severe bear markets of the past century: the Great Depression (as measured by the S&P 500 Index between September 1929 and September 1949); the oil shock and stagflation of the 1970s (S&P 500 between March 1973 and March 1993); Japan's "Lost Decades" (Nikkei from April 1990 to June 2009); and the Internet Bubble-Great Bubble (S&P 500 since March 2000). All four series begin at an epochal market maximum, and all except the most recent cover 20 years. Further, each series has been discounted by the CPI and standardised to a common starting value of 100.

The most basic result is hardly surprising: bear markets can last an interminably long time and inflict cumulatively and unexpectedly brutal punishment upon investors. In two of the three cases for which two decades of data exist, 20 years after the boom market indices had still not returned (in CPI-adjusted terms) to the boom-time maximum. And in none of the four cases had they done so after ten years. But no bear is the same. Which was the worst? That depends, among other things, upon the interval of time under consideration. The descent of the Nikkei has inflicted the severest punishment over the longest interval: a portfolio that mimics it fell from 100 in 1990 to 28 in June 2009 – that's a cumulative loss of purchasing power of 72%. Year after year for 20 years, in real terms the Nikkei has fallen at a compound rate of 6.3% per annum. Since 2000, the S&P 500 has fallen from 100 to 55, i.e., at a compound rate of 6.2% per year; and between

1929 and 1949, it fell from 100 to 34, or by 5.5% per year in real terms. Only from 1973 to 1993 did it increase – from 100 to 121, a compound rate of 0.8% per year in real terms.

**Figure 12:
Some Epochal Overseas Market Highs and Their Aftermaths**



Which was the worst bear market? Over five or fewer years, the Great Depression took the prize. The S&P 500 collapsed 80% in fewer than three years. Over that interval, the Nikkei plunged merely 57% over 3½ years, from 1973 to 1975 the S&P 500 fell by 50%, and from 2000 to 2003 it decreased by 45%. After ten years, each inflicted roughly the same (45-55%) amount of cumulative damage, equivalent to a compound rate of decrease of 6.5% per year. Each of these long bears was punctuated by sharp bear market rallies (Table 8). But it was all to no avail. These false dawns should (but probably won't) temper the bulls' enthusiasm about the rise of Australian and other market indexes since March of this year.

**Table 8:
Bulls Beware! Short and Sharp Rallies Routinely Occur
During Long Bear Markets**

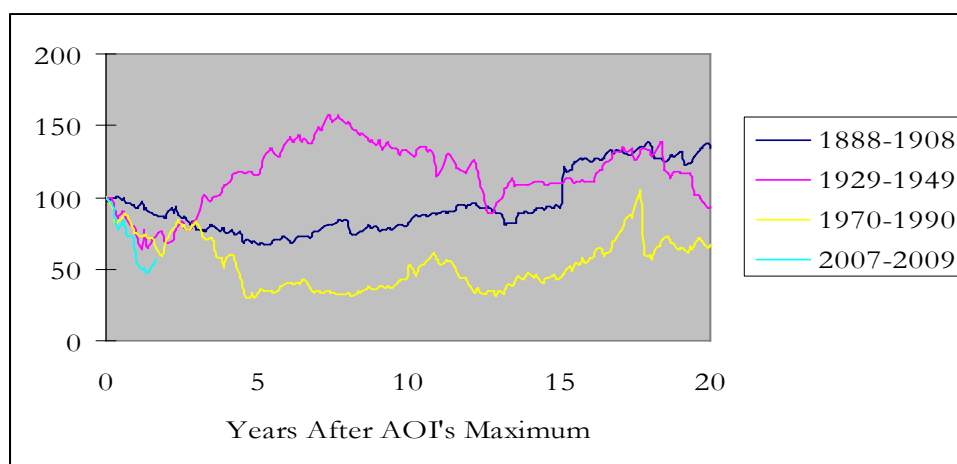
| | No of Market Rises of 20%+ Within 6 Mo | No of Market Rises of 25%+ Within 6 Mo | No of Market Rises of 30%+ Within 6 Mo |
|--------------------|--|--|--|
| All Ords 1888-1908 | 0 | 0 | 0 |
| All Ords 1929-1949 | 5 | 3 | 1 |
| All Ords 1970-1990 | 44 | 25 | 16 |
| Nikkei 1989-2009 | 23 | 16 | 7 |
| S&P 500 1929-1949 | 29 | 22 | 12 |
| S&P 500 1973-1993 | 26 | 9 | 3 |

What does the future hold? Figure 12 suggests two possibilities: one is merely bad, and the other is much worse. The merely bad possibility conforms roughly to

years 11-20 of the series that commenced in 1973. If so, then it recoups most of its losses and regains the 100 barrier – but still records a 20-year return, net of CPI, which fails to match the average cash rate during that 20-year interval. The much worse possibility is that it conforms roughly to years 11-20 of the Nikkei series that commenced in 1990 and the S&P series that began in 1929. If so, then for years it grinds in a generally negative direction and cumulatively destroys the bulk of a portfolio’s purchasing power.

Do these results apply to The Lucky Country? Figure 13, which depicts the four most severe bear markets in Australian history, suggests that they could. These bear markets are the Depression of the 1890s (as measured by the AOI between November 1888 and November 1908); the Great Depression (AOI July 1929-July 1949); the Whitlam-Fraser stagflations of the 1970s and 1980s (AOI January 1970-January 1990); and the Great Bubble (AOI since October 2007). Again, the series begin at an epochal market maximum, and all except the most recent cover 20 years. Further, each has been discounted by the CPI (for the first series, the Melbourne producer and consumer indices compiled between 1855 and 1925) and standardised to a common starting value of 100.

Figure 13:
Some Epochal Australian Market Highs and Their Aftermaths



As it was overseas, so too in Australia: major busts last a long time. In two of the three cases for which two decades of data exist, 20 years after the boom market indices had still not returned to the boom-time maximum. Which was the worst bear market? Again, that depends upon the length of time under consideration. The 1970s-1980s inflicted the severest punishment over the longest interval: a portfolio that mimicked the AOI during the 20 years from January 1970 fell from 100 to 67 – a cumulative loss of purchasing power of 33%. Year after year for 20 years, in “real” (as opposed to “nominal”) terms the AOI fell at a compound rate of 2.4% per annum. Between 1929 and 1949, it fell from 100 to 94, or by 0.5% per year in real terms. Between 1888 and 1908, it rose from 100 to 135, or by 1.5% per year in real terms. From October 2007 to June 2009 (it’s early days yet), the AOI fell in real terms from 100 to 57, i.e., at a compound rate of 24.5% per year.

Which was the worst bear market? Over two years, the most recent (Great Bubble) is the worst; and over three years, the 1890s, 1930s and 1970s were equally bad. Over longer periods of time, the AOI recovered erratically but reasonably gradually 5-15 years after the market maximum in 1888. The 1930s and 1970s series behaved very differently. The AOI rose very strongly (from 70 to 160) from 1931 to 1936; thereafter, however, it fell to 90 by 1941, rose to 130 by 1947 and then relapsed to 94 in 1949. Each time, a galloping CPI did the damage. (Indeed, if the series that ended in 1949 had been extended to 1954, it would have closed at 48. That's a cumulative loss of more than 50% over 25 years.)

These days, few know or care that the 1970s damaged Australian portfolios much more brutally than the 1930s. The AOI fell from 100 in 1970 to 30 late in 1974, and remained in the low-30s until 1983. It then rocketed upwards, breaching 100 in 1987, and shortly thereafter collapsed by almost half. In 1990, it stood at 67 – thereby inflicting a cumulative decrease of 33% upon investors' purchasing power. As in Japan and the U.S., so too in Oz (particularly in 1970-1990): Table 8 shows that major bear markets other than 1888-1908 were punctuated by the false dawns of numerous sharp bear market rallies. *Indeed, the more severe is the bear market, the more numerous are the bear market rallies and the dispiriting false dawns they create.*

What does the future hold for today's All Ords? If the Great Bubble burst and a long-term bear market commenced in October 2007 (see [Leithner Letter No. 96-98](#)), then Figure 13 suggests three possibilities: one is bad in the long term but very good in the medium term; and irrespective of the interval of time, the second is ugly and the third is horrendous. The first possibility – which today's market participants seem to regard as a strong favourite – resembles the AOI's trajectory from 1931 to 1936: that is, a very sharp increase that recoups all of the losses incurred during the bust, and also adds significant gains. The second possibility is that the future reprises the 1890s bear market, namely a very long (15 year) slog that recoups the losses of the bust but adds no gains. It's ironic that the horrendous possibility, which occurred within the lifetimes of many of today's investors, is the one that virtually everybody ignores. If the AOI's subsequent trajectory looks anything like years 5-10 of the bear market that commenced in 1970 then during the next several years Australian investors will suffer dreadful losses. If the 1970s is our future, then the AOI will breach the "low" of March 2009 (3,250) and could eventually fall as low as ca. 2,200 (see also [Leithner Letter 114-116](#)).

What Would Ben Graham Say About Today's Market?

Has the Worst Passed? Let's Hope Not!

It happens repeatedly: upon reflection, we conclude that what we initially thought was good news is actually bad. Similarly, what we at first regarded as bad news occasionally has a sufficiently thick silver lining that it eventually qualifies as good. If, for example, "stimulus" is actually poison, then one day Australians will curse it as fervently as they presently applaud it. And if a recession and accompanying bear market is actually the necessary and unavoidable means by which poor poli-

cies are repudiated, debt purged and savings rebuilt, then one day Australians will accept it as a necessary condition of genuine recovery.¹² Hence Ben Graham counselled that the investor must analyse rather than emote; he must neither rejoice at “good” news nor despair at “bad” news. At the same time, to the extent that his reason cannot suppress them, the investor should retrain his emotions so that they diametrically oppose the crowd’s. In other words, he should be fearful when the crowd celebrates and exultant when it cowers. Graham recognised that our heart is not a tap that we can (or even should) turn on and off at will. But if he was correct, in matters financial it should be a course of water whose direction our head can sometimes influence.

Since the first week of March, stock market indices around the world have risen by 40-50%. In the autumn a wave of relief swept the crowd, during the winter it began to rejoice and now that spring has sprung the conviction has appeared: the worst has allegedly passed, “green shoots” are supposedly sprouting and before too long all will once again be well. If he were here today, it’s very unlikely that Graham would share these sentiments. He was a keen and lifelong student of Classics (upon his graduation, Columbia University offered him a chair in his choice of Classics, English or Mathematics; he declined them all in order to go to Wall Street). Not surprisingly, he regarded “the investor’s chief problem – and even his worst enemy – [as] himself.”

To know oneself is to master one’s emotions. In an autobiographical sketch, Graham “embraced stoicism as a gospel sent from heaven.” Among the bulwarks of his “internal equipment” was “a certain aloofness” and “unruffled serenity.” His third wife described him as “humane, but not human.” His eldest son recounted “his mind was elsewhere, and he did have a little difficulty relating to others. He was always internally multi-tasking. Maybe people who go into investing are especially well-suited for it if they have that distance or detachment.” In the final years of his life, Graham remarked that his immersion in classics, literature, maths and philosophy helped him to view developments in economics and finance “from the standpoint of eternity, rather than day-to-day.”

Perhaps as a result, Graham took others’ enthusiasm as grounds for caution and their fear as a sign of hope. His knack for inverting emotions (and interpreting financial statements) helped him to see when people embraced extremes. In 1974,

¹² According to Jose A. Tapia Granados and Ana Diez Roux, economic depression increases longevity more than diet or exercise do. Life expectancy during the worst years of the Great Depression increased from 57.1 years in 1929 to 63.3 years in 1933. It didn’t matter whether you were a man or a woman, or black or white; and it didn’t matter if you resided in the U.S. or in Spain, Japan or Sweden during their busts. By contrast, life expectancy declined during the boom years. For most age groups, “mortality tended to peak during years of strong economic expansion (such as 1923, 1926, 1929 and 1936-1937),” they wrote in the September 2009 issue of *The Proceedings of the National Academy of Sciences*. Conventional wisdom holds that recessions are times of stress. Moreover, people can’t afford to eat properly, go to the doctor, etc. Hence they should drop dead sooner. Instead, they live longer. Perhaps as the economy crashes, people live at a more comfortable pace. Maybe the unemployed get more sleep. We don’t know. But if you want to live an extra six years, a slump is your best friend. For personal as well as economic health, nothing beats a depression.

he correctly prophesied a period of “many years” in which “stock prices may languish.” He quickly added, however, that a long bear market is good news, not bad: “the true investor would be pleased, rather than discouraged, at the prospect of investing his new savings on very satisfactory terms.” He concluded that investors would be “enviously fortunate” to benefit from the “undoubted advantages” of an extended bear market. The bear, in short, is a gift; and the longer it lasts, the better off will be those who have properly prepared themselves for it.

Is This A New Bull Market or a Run-of-the-Mill Bear Market Rally?

Whither the All Ordinaries and other stock market indices? The conviction of the crowd is hardening: the “low” occurred on 9 March, we won’t return to it and anybody who thinks otherwise, never mind his reasoning and evidence, is a “permabear” who should be either ignored or ridiculed, but certainly not heeded. The contention (which the bulls don’t state explicitly, and certainly don’t justify, probably because it’s so obvious to them that they regard it as utterly unarguable) is that a rise of major market indices by 30% or more within six months is a sufficient condition of the end of a bear market and the start of a new bull market.

But is it necessarily so? Table 8 suggests rather strongly that it is not. The analogy of Daniel Turov (“Mixed Message,” *Barron’s* 21 May 2001), together with financial history, makes much more sense than the relentless cacophony emitted by journalists, “market strategists” and various other babblers. “Bear markets don’t act like a medicine ball rolling down a smooth hill,” said Turov. “Instead, they behave like a basketball bouncing down a rock-strewn mountainside; there’s lots of movement up and sideways before the bottom is reached. During the Great Bear Market from 1929 to 1942, the Dow Industrials had rallies of 48% (from November 13, 1929 to April 17, 1930), 94% (July 8, 1932 to September 7 of that year), 121% (February 27, 1933, to February 5, 1934), 127% (July 26, 1934 to March 10, 1937), 60% (March 31, 1938 to November 12 of that year) and 28% (April 8, 1939 to September 12 of that year). Yet, on April 28, 1942, the DJIA was still at only 92.92, 76% below its September 3, 1929, high of 381.17.”

Turov added “when the bulls stop asking ‘is this the bottom?’ and instead are explaining to their friends why ‘this time it’s different, and the market really is a bottomless pit,’ then it will be time for me to pen ‘Buy Signal, Part 2.’ But we’re a long way from that.” His conclusion applies just as much to Australia as to the U.S. As such, it should – but probably won’t – give the Australian herd pause: “the Dow first reached the 100 level in January 1906. It traded above and below that level for more than 36 years; it wasn’t until May 1942 that the market left 100 behind for the last time. The Industrial Average first reached 1,000 in February 1966. It traded above and below that level for the next 17 years, leaving that figure behind for the last time in February 1983. The Dow first reached the 10,000 level in March 1999. Considering the unprecedented gains of the past several years, would it be that unusual for this bench-mark to take a decade or even two before leaving 10,000 in the dust for the last time?”

On 17 September, *The Wall Street Journal* (“The Dow Will Hit 10,000 Soon: So What?”) updated this point, and reminded us about the insidious affects of the CPI’s rise:

The Dow Jones Industrial Average has risen 1,000 points since the middle of July. At 9,783, it’s within hailing distance of 10,000 – a level not seen since last October. What does this mean for you and your portfolio? Not much. It’s ten years and six months since we first passed the 10,000 milestone. Since then we’ve passed it several more times – in both directions. It doesn’t mean the markets are back to where they were: since the Dow first hit 10,000 back in March 1999, the dollar has lost 23% of its purchasing power. So in March 1999 dollars we’re still only back to about Dow 7,500. Thanks to [the effects of the central bank’s] inflation, each “Dow 10,000” is worth less in real terms than the previous one.

A Back-to-the-Future Value Strategy

If they had adhered rigorously to it, would the traditional “value” approach to investment pioneered by Ben Graham have protected Australian investors from the “Global Financial Crisis” that finally erupted in the middle of 2007? Would it have generated reasonable results over the past decade? The answer, I believe, is “yes.” Most approaches to investment – including those that embrace the phrase “value investing” but disregard or repudiate its assumptions and methods – bled profusely during calendar 2008 and into 2009. Accordingly and unfortunately, few market participants benefitted from the protection that genuine Grahamite investing could have afforded. One of the ancillary benefits of the recent panic and extended bear market (if that it what we are experiencing), therefore, may be to re-acquaint investors worthy of the name with the advantages of paying proper attention to value.

Such an atonement would be a fitting 75th anniversary/commemoration of what has become the definitive textbook on investing – *Security Analysis*, which is now in its 6th edition. Because Graham honed his thinking during the Great Depression, his definition of value was very strict. Rather than define it in relative terms, as do most of today’s so-called “value” managers (“what I’m buying is less over-valued than what you’re buying”), he defined it in absolute terms. That meant that there would be times when the values of few if any securities exceeded their prices. At the depths of the Depression, hundreds of stocks on the NYSE satisfied Graham’s criteria. In subsequent decades that number fell greatly; and by the late 1980s and 1990s there were many occasions in which no more than a handful could satisfy it. An investor who stayed true to Graham’s criteria would therefore – like Leithner & Company during the past decade – have had no choice but to accumulate an increasingly large position of cash and bonds.

LCO’s results rebuke those who think that this would have hopelessly handicapped long-term results. So do model portfolios in *Growth Stock Outlook*, a newsletter edited since 1967 by Charles Allmon. Though he has not adhered unerringly to Graham’s principles or definition of value, over the years he has remained truer than any of the other (ca. 180) newsletters that the *Hulbert Financial Digest* (HFD) monitors and analyses. According to HFD, Allmon’s model portfolios have

achieved some of the best long-term results of any newsletter. What would Graham be advocating now? We can't be certain, but according to a *The Wall Street Journal* (30 April) Allmon's outlook remains resolutely dour. He suggests that stocks comprise no more than (and preferably less than) half of investors' portfolios. Expressing little confidence that governments and their crazed interventions will achieve their intended positive results, and even being even less sanguine that they will avoid unintended negative consequences, Allmon concludes "the trick now is to avoid being scalded in a sea of nonsense."

Conclusions

Benjamin Graham has long and rightly been lauded as the founder of investment analysis. Yet his principles and methods, detailed in *Security Analysis* (1934) and *The Intelligent Investor* (1949), have not often been emulated. Others' loss is our gain; these principles and methods have served us well. For the past decade, they have enabled Leithner & Company to preserve its shareholders' wealth: LCO has compounded its per-share capital at a rate which has exceeded – and thus compensated for the effects of – the inexorable rise of the Consumer Price Index. LCO has also built its shareholders' wealth: it has invested its capital in a portfolio of securities whose compounded rate of return (in "real" as well as "nominal" terms) has exceed that offered by 5-year Commonwealth Government bonds (for a summary of results, [click here](#)).

We've applied Graham's principles and methods at a time of fiscal and monetary chaos. The U.S. Government and the régimes of other major Western nations are – not least because they're ruled by kleptomaniacs and economic illiterates who are in the pockets of plutocrats – morally as well as financially bankrupt. The state's inflation (all insiders, regardless of party affiliation, embrace the central bank's interventionism) is both the glue that holds the state together and the poison that impoverishes outsiders. The Fed's (and Bank of England's and RBA's, etc.) willingness to respond ever more aggressively to each successive perceived threat has produced a reckless monetary policy which has and will continue to destabilise economies and financial markets. Alas, fiscal and monetary "stimulus" fixes nothing today; even worse, it bequeaths even bigger problems to the future.

Hence I expect that the next decade will resemble the 1970s more than either the 1930s or the 1990s. I anticipate an extended period of stagnation or outright recession, falling asset prices and rising consumer prices and interest rates ("stagflation"). If it reprises the Australian experience of the 1970s, the next decade will also feature sharp bear market rallies (I believe we're in the midst of one now), as numerous as they are ultimately dispiriting, which falter and lead to even lower lows.

The good news is that our very large holding of cash, Grahamite philosophy and cautious expectations about the future dovetail. If we're in the early stages of a long bear market, and if the prices of stocks resume their decrease, I will gradually and selectively increase stocks' weighting in LCO's portfolio. If our assessment of

the road ahead is roughly correct, then this shift will stand us in good stead. A rising CPI harms returns by causing capital losses; it does not, by and large, harm the CPI-adjusted value of dividends. A focus upon dividends during such times therefore helps to maintain total real returns in positive territory. The more our total return derives from dividends, in other words, the less a rampaging CPI will trash it over time. Further, the greater the dividend as a percentage of one's total investment return, the more stable – and positive – that total return will tend to be over the years.

But what if we're wrong? What if the next decade resembles the 1930s or the 1990s more than the 1970s? Periods like the 1930s, when CPI fell well below zero, were no friend to those who craved capital gains; but they were reasonably kind to returns from dividends. Extended periods when the CPI is "low" (which the mainstream defines as an increase of ca. 2% per year) are most conducive to strong results, particularly from capital gains. Not surprisingly, the bulls clamor for the reappearance of the "low inflation" 1990s: it provides an opportunity to recoup some or all of the losses they've incurred since 2007. But such an interval is very much the exception rather than the rule. No Western central bank other than Switzerland's and to some extent Germany's has ever stabilised consumer prices for an extended period of time. Relatively brief intervals of stability have been followed by periods of briskly rising prices. Today's bulls are unwittingly (and I think erroneously) assuming that the economic and financial "norm" of the Great Bubble was actually normal, and that it will shortly return.

So do politicians and bureaucrats – who, since mid-2007, have attempted to recreate the "normal" conditions that prevailed during the Great Bubble. They have injected into Mr Market's veins a fiscal and monetary narcotic no less than seven times stronger – in terms of GDP – than the average post-war countercyclical stimulus. This "upper" has revived him, and he's regained his feet, but he still staggers. He's not so young anymore, his liver's not the best and he's gained weight over the years: he now carries three times as much debt to GDP as he did in 1982, and stocks are three times as dear (in terms of their average price-to-earnings ratio), as they were then. What's more, in 1982 he had been following a strict ("deleveraging") diet for almost a decade; in 2009, he's barely commenced such a regimen. If we're wrong and Mr Market suddenly displays rude health, we'll do less well than we have hitherto; but if he relapses – that is, the bulls are as wrong in the next decade as they were in the last – they'll do even worse than they have since mid-2007. As in the past ten years, so too, apparently, in the next: the crowd's stampedes are considerably riskier than Leithner & Co.'s deliberately slow, unconventional and above all consistently Grahamite gait. For the crowd's sake, and for Glenn Stevens', let's hope that – unlike the decade just concluded – its results compensate for the risk it's taking.

Chris Leithner