Quarterly Newsletter - October 2015

October 15, 2015

Dear Client,

Should they do it or not? And will they do it or not? And what will happen if they do do it? And what will happen if they do not do it? This sounds like a Shakespearian comedy plot. But it is no comedy, and a wrong decision would be neither fun nor funny. The debate, in the press and in the markets, is hot and heavy. The ?it? is ? ?raise interest rates'. And the ?they? is ?the U.S. Federal Reserve'. The question at issue is, should the Fed raise short term rates? ? which Janet Yellen, Chair of the Board of Governors of the Federal Reserve, insists she wants to do and do before year end.

The economic rationale for a rate increase is hard to find. The standard justification for an increase is to cool off an economy that is running ?too hot?, where too hot means too much inflation. Where is the inflation ? either in prices, or more importantly in wages? There just isn't any anywhere. Inflationary expectations in the U.S., as measured by the five year five year forward TIPS spread, are collapsing. The 30 year inflation forwards are predicting 1.6% annual inflation for the next 30 years! Social Security recipients are not expected to receive any cost of living increase for 2016 ? only the third time in over 40 years this has occurred. European monetary policy is stone tight and profoundly deflationary. Europe is thus importing much less from China than before, and therefore China is slowing and also importing less. This means falling commodity prices. Oil has fallen by nearly 50% in the last year. The emerging markets are collapsing as commodity prices fall. The world economy is showing clear signs of heading into a deflationary slump. In the U.S. layoffs are beginning again. U.S. unemployment would be over 10% if discouraged workers were counted in the sample. U.S. labor force participation is at a forty year low. There is a common cause to all of this, namely monetary policy that is much too tight all over the world. And yet the Fed continues to about talk raising rates. This kind of talk in fact already tightens money as people anticipate the promised tightening.

There are many theories, some conspiratorial and some entirely nutty, as to why the Federal Reserve is doing this. Ray Dalio and Jeffrey Gundlach, both of them well respected investors, are predicting that Fed will in fact eventually be forced to cut rates, not raise them. And many other eminent publications (and most especially the Economist magazine) are basically begging the Fed ?don't do it, please? (See the editorial in the September 25 Economist entitled ?After the hold, be bold? for an example.)

Inflation benefits debtors. Deflation benefits creditors. Some more inflation would mean more economic optimism ? less fear of a fall in future income and therefore freer spending. This would create more investment, and thus more growth and more employment. There are many ways the Fed could create some inflation and thereby reduce real interest rates if they actually wanted to do so. These range from a cash financed budget deficit to Milton Friedman's ?helicopter money? (no leftie he), to Nominal Gross Domestic Product (NGDP) Targeting. (Do Google a search on NGDP Targeting for details).

The simplest and quickest way would be for the Fed to just directly say that they want much stronger growth, say 6%/year growth in nominal income for at least 2 years, and that they will go a very long way to achieve it. Janet Yellen could announce that the Fed will keep rates low, and will restart quantitative easing, and will buy anything not nailed down until the economy actually is running hot. If the Fed did say this, out loud, they very likely would not have to buy one single thing. The markets, both goods and financial, would do the buying for them. They would likely take off like rockets, and this whole nightmare would be behind us. That at least is what happened when Roosevelt came in in 1933. He immediately announced an increase in the dollar price of gold ? which was a direct statement that The President of United States, having just won a gigantic majority and with complete control of Congress, wanted an end to deflation was willing to do whatever he had to do to get it. Confidence replaced fear. Employment and investing came roaring back and the much of the damage done by the 1929-1932 collapse was reversed within six months. A good description of Roosevelt's reflation plan and the electric effects it produced is contained in the blog post from themoneyillusion.com entitled My Role Model, George Warren. We urge you to read it.

This sounds like a real pessimistic and bitter letter. It is bitter, but not pessimistic. In fact this letter is quite optimistic. What we are saying is that the current global economic malaise is not the result of real economic factors, such as for example a deteriorating natural environment or a declining labor force as people age and retire. These kinds of things are difficult or impossible to reverse. The malaise is rather the result of policy errors. If the Fed were to openly state that they will prioritize growth over inflation-phobia we believe the markets would go up very much and very fast.

And if you say ?Yes, but get real. That will never happen? please recall that the U.S. suffered through three years of grinding deflation from 1930 through 1932. The result was the political revolt known as Franklin Roosevelt. There are very surprisingly powerful insurgencies going on in both political parties now ? The Donald and Bernie Sanders, both with the same basic economic message? deep and entirely legitimate anger at the policy elite known as the Federal Reserve. There have been many articles, in the NYT among others, detailing the fact that the vast majority of the benefit of the (deliberately squelched, deliberately low inflation, deliberately non-strong) non-recovery since the 2008-2009 crash has gone to the ultra-rich, while the middle and low income people have been left with very much reduced economic, financial and life prospects. If the Fed continues to prioritize low inflation over higher employment and faster growth it should surprise no-one if one or another of these insurgencies were to win the Presidency.

The investment result of all this is exactly where we have always been. We do not know which outcome will win. But capitalism plus democracy has shown an amazing capacity for recovery and self-healing over the longer term. We believe, as we always have, that should dark forces crash the markets (as they always could do), the rational response will be to buy them while they are cheap ? not to run away. Please remember that by far the best time there has ever been to buy U.S. equites was the dark pre-Roosevelt days of 1932. When things get tough the tough get going. That remains our investment method and advice now.

With this letter we are enclosing a report called the ?Twelve Month Asset Class Performance Summary?. Our aim is to show our rebalancing method in action in your portfolio. This report shows both the flows and the actual performance, by asset class, of your portfolio for the past twelve months. The IRR column shows the percent return for the asset class. The Net Flows column details the rebalancing activity. A negative number (in parentheses) in that column means money left the asset class. A positive number means money went into the asset class. As you know, our method is to take money from the asset classes with the higher returns and put that money into the low return asset classes. Over the past twelve months this has meant money leaving Fixed Income and U.S. equites and going into international equities and especially the emerging markets. This happened because, for the reasons detailed in this letter, the emerging markets have had a terrible year, and we are therefore buyers. We will publish this report quarterly.

Please contact us with any questions on this letter, the new report or anything else financial.

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