

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Afternoon Bullet Points January 22, 2008

We've now had five months of on-again/off-again crisis in the U.S. A big reason this mess drags on is that the people running U.S. monetary and fiscal policy are, technically speaking, incompetent.

Points:

1) The Fed's 75-bps cut is a logical move within the current (warped) policy framework. Markets could rally on this news, but they don't necessarily have to. By throwing liquidity into the system, Fed Chairman Ben Bernanke may assuage some immediate liquidity problems, but he is also creating *new* problems. We are moving into the realm of amazingly-loose monetary policy, and thus heightened inflation risk.

2) It's a good sign (near-term, at least) that gold is rallying. Gold almost always falls during panics, because investors seek the safety of the dollar. As panics end, gold usually goes back to where it had been before. Since the current panic is being addressed via a big rate cut, gold easily could go much higher than it had been (i.e. over \$900/oz.). U.S. monetary policy post-crisis will be far looser than it had been pre-crisis (and it was already extremely loose). In theory, we could see \$1,200/oz. gold very soon. Gold could take another header if we get intensified panic, but eventually the situation is likely to be resolved with gold moving upward.

3) Commodity stock valuations are just flat-out ridiculous. They make NO sense within a classical economic model. Plenty of stocks are trading at 4x earnings based on prevailing commodity prices (which themselves are down considerably from peaks).

4) In principle, weakness in home prices, equities and bank balance sheets do not have to create a recession. The official supply-side view is that these are *balance-sheet* disturbances, and thus distinct from income-statement disturbances and (more importantly) policy changes that influence behavior of entrepreneurs. For me personally, it's hard to be too doctrinaire on this point. After all, we are certainly seeing evidence of slowdown throughout the economy right now, some of which stems from housing-price weakness.

5) What we're really confronting now is not so much economic weakness *per se* as transition into an overtly inflationary economy. In other words, we're going back to the 1970s. As such, the logical market leaders coming out of this crisis should be the commodity stocks. It's true that global economic softness could crimp certain commodity prices *relative to gold* (because commodity prices are impacted by industrial demand and the gold price isn't). But if gold rises, commodity prices should at least stay level in nominal dollar terms, and they really ought to rise.

6) An inflationary economy is bad news for a variety of non-commodity sectors, and the broader equity indices could thus have tough sledding in coming quarters (and years). Financials, consumer sectors and utilities all suffer heavily from rising inflation – both in terms of earnings and P/E ratios. *These sectors have a lot of market cap behind them*, so when they suffer the broader averages suffer too. One additional possibility is that these sectors remain flat in nominal terms while the real value of the dollar falls. This scenario wouldn't *look* like a bear market, but it most definitely would *be* a bear market in real terms.

7) One could think of the new environment as the "anti-Peter Lynch" period. The conventional wisdom is that Lynch made his money by investing in brands that everyone had heard of and understood. What Lynch really did, though, was buy companies that *consumed* commodities (which were falling in the '80s and early '90s) and *produced* products for sale on store shelves (where prices were rising in response to the currency devaluation of the '70s). Margins widened, profits rose, P/Es expanded. These days, one doesn't hear much about Lynch because his principles haven't worked since 1997. Looking forward, they're likely to aggressively *not work*.

Consider the food-processing sector. These firms (Kellogg's, Smithfield, Tyson, etc.) will be buying inputs at quickly-rising prices and selling products on store shelves at *slowly*-rising prices. They'll get squeezed. This process has already started with the meat and poultry processors.

8) U.S. monetary policy is in a state of intellectual disarray not seen since the 1970s. Policy has been steadily deteriorating since the late '90s, when former Fed Chair Alan Greenspan took it upon himself to impose a monetary deflation on the U.S. (and world) economy via punitive interest rates. This led to the deflationary recession of 2001-02, which, in turn, prompted Greenspan to slash interest rates excessively, spawning the monetary *inflation* now underway. Both the housing boom *and the bust* were stepchildren of Greenspan's exercise in central planning.

9) Bernanke now faces a truly bizarre confluence of events: a housing bust in the middle of a monetary inflation. The situation would be laughable for its stupidity if the implications weren't so troubling. But this is the sort of screwy situation that always develops when monetary policy is based on a lie, as U.S. monetary policy is. From the early '80s until 1997, the Fed generally made decisions with one eye on commodity prices. Today, Bernanke's decisions are made with absolutely no reference to commodity prices. The stability of the dollar's real value in the '80s and early/mid '90s was one reason why that period was good for equities. That stability is now gone.

10) Volatility in interest rates is becoming a risk factor in its own right. The Fed has been overshooting on a very regular basis for the past 11 years, and the *pace* at which interest rates are being whipped around is starting to be a structural impediment to investment, in the sense that it is generating loopy signals as to where capital is most needed. Entrepreneurs find it hard to function in such an environment. The Fed's obsession with fine-tuning the growth rate is counter-productive. It's a consequence of the false belief that inflation is caused by excessive growth.

If the Fed moved to a price-rule monetary policy, much of this interest-rate volatility would go away. That's not going to happen anytime soon, though, because certain powerful constituencies *benefit* from volatility. Jude Wanniski used to refer to these constituencies collectively as the "chaos industry." Investment banks, for instance, benefit from chaos in the same way that accountants benefit from a complicated tax code. Chaos makes average citizens feel helpless with their own savings, while simultaneously creating speculative opportunities for insiders who know how to exploit price inefficiencies. Investment banks wind up with everybody's money – either as assets under management (run by "professionals") or as cash on their own balance sheets.

It's interesting to me that there is much more acceptance of gold's role as a monetary signaling device on Wall Street than there is at the Fed or in the academic community. Plenty of money managers and investment people understand gold, at least to some degree. But you never hear the big banks call for a price-rule monetary policy (with the occasional exception of Bear Stearns). They don't do this in part because monetary stability would destroy their competitive advantage. Before long we may start hearing "conspiracy theorists" saying that the country is being impoverished for the benefit of Goldman Sachs. They will be right, of course, but they won't know precisely *why* they are right, and thus will be conveniently ignored.

11) The presidential candidates all are clueless about monetary policy (except for Ron Paul, who, not coincidentally, has been written off as a nut). Political commentators often debate the merits of the candidates' tax policies -- but you never hear a peep about monetary policy, either from the pundits or the candidates themselves. That is because neither the candidates nor the pundits *understand* our monetary policy (for the simple reason that it defies understanding). A hundred years ago our monetary policy was intelligible. An entire election (1896) was fought on the question of whether the U.S. should be on a gold standard or a (weaker) bi-metallic standard. Today, the whole subject of monetary policy is practically taboo in politics.

12) Foreign markets have been panicking over the past few days in part because foreigners are aghast at how idiotic American policy proposals have become. For our executive branch to propose sending out \$800 checks is bad enough. For the Fed Chairman to bless the proposal is

downright disturbing. Things could get worse in coming months. If gold blows through \$1,100/oz. and CPI climbs to 6%, one could easily visualize any of the potential Democratic nominees calling for price controls, first on petroleum products, then on food products.

The Bush tax-rebate plan is an insult to the intelligence of any thinking person – but perhaps its very idiocy (and failure to restore investor confidence) will prompt the administration to consider some pro-growth measures instead. President Bush's best act as president was to push through his 2003 tax-cut package, and then defend it against calls that it be weakened or rolled back. Perhaps Bush will reach into that same reserve of pro-growth common sense and choose another pro-growth fiscal policy action to improve investor confidence.

13) CPI will show up in emerging markets before it shows up here, because contract lengths are shorter there. Bernanke's rate-cutting tactic could thus boomerang back at us in the form of bizarre policy actions by emerging-market governments and central banks. Gold is rising in all currencies now, and truly gargantuan CPI numbers could pop up in all sorts of places. Policymakers do strange things in such situations (price controls, capital controls, etc.).

14) In recent months, I have been wrestling with some deeper philosophical issues that I haven't quite been able to pull together into a coherent piece. Here are a few thoughts:

- The U.S. is suffering a crisis of leadership that is larger than the personalities themselves. Our political system seems to be demanding an *increasing* amount of demagogic rhetoric from all candidates -- left and right -- on economic policy. The cold truth of capitalism is that entrepreneurs are the drivers of the economy. As such, they matter more than other people to the health of the economy. That's why tax cuts for the "rich" work and tax cuts for the poor don't. But a politician cannot say that and get elected. Over time, then, the populace simply *forgets* that there is a relationship between fiscal policy and economic growth. This particular nugget of wisdom falls out of common knowledge. The result is moronic policy proposals such as the \$800 rebate.
- Machiavellianism is on the rise in our politics now, and it traces back, at least in part, to the philosopher Leo Strauss. Strauss was the intellectual godfather of the neoconservatives, many of whom studied directly under him or under his top students (Allan Bloom and Harvey Mansfield). It was Strauss's revival of the Platonic concept of the "Noble Lie" that inspired the neoconservative marketing strategy for the Iraq war. I find Strauss to be a fascinating thinker but, as with Nietzsche, it's not hard to see how his ideas can be twisted to serve evil ends.
- Although the lies behind the Iraq War have been exposed – *the revival of conscious Machiavellianism appears to be here to stay*. We see it, for instance, in the pandering of the Bush administration to the religious right. None of the top Bush people are really anti-gay (Rice, Cheney, Rove), but they support anti-gay policies to keep the fundamentalists happy. The same hypocritical approach applies to bioethics: It's *not* okay to use stem cells for medical research, but it *is* okay to clone animals.
- The increasing recourse to the Noble Lie among policymakers leads to a situation where we are constantly forced to choose whether our leaders are a) incompetent or b) phony. Ben Bernanke is incompetent if he thinks an \$800 rebate will do any good, and he is phony if he knows it *won't* do any good but blesses it anyway. Mitt Romney is incompetent to be president if he believes God directed Joseph Smith to a set of golden plates in a hill near Manchester New York in 1827. He is phony if he doesn't believe that yet says he does. This isn't meant to be a gratuitous stab at Mormonism -- it's an absolutely crucial point. This is where our political discourse is now. Romney, who in many ways is the best-qualified of all the candidates to be president, feels he must demagogue on a host of key social issues in order to get elected. It is thus perhaps reassuring that John McCain is becoming the Republican front-runner, since he is not particularly phony (though Romney may yet redeem himself).

- Republicans are the keepers and protectors of pro-growth economic ideas. As such, when Republicans lose credibility by lying in non-economic realms (i.e. foreign policy, social policy), the prospects for pro-growth policy are weakened as well. That's bad. If the Democrats win in 2008, we will likely be reliving the Carter years. Last week I listened to a conference call by Obama economic point man Austan Goolsbee. I like Obama, but Goolsbee knows nothing. He is a pure Keynesian. If he's Treasury secretary a year from now we'll have to break out the Shaun Cassidy records and bean bag chairs for the office because it will be the '70s all over again.

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