Or so it seems to me . . .

This Quarterly will focus further on the New Economic World we seem to be in. Optimistic because of our strengthening recovery, I also am cautious about some elements that have taken root in our country. The time frames are two: The next very few months and a point sometime in 2016. I am indebted to a litany of writers, economists, pundits and just plain brilliant folks for some of the triggers to these views including Laffer, Rubini, Hu, Rosenberg, Hyman, Brock and Wolf, among others.

My rough analysis looks at the following broad areas:

Convergence	**Speed**	**Return of the Kings**
What Business Cycle?	**Common Country Goals**	**Demographics**

I have elected to treat these topics separately in the hope that the reader will see them as pieces of the same, much clearer, New Economy. I like a thought line to be gathered in one place, but seldom succeed myself, so this is a renewed attempt at clarity.

<u>Convergence</u>

In *Navigating the Reef* (October 2010), *Street Fight* (July 2010), *Snap* (July 2011) and particularly, *Civilization, Act 2* (April 2011), I tried to establish the potential for an American population beginning to act in concert from a gene-driven, near-primitive instinct rather than as the isolated souls we see today. In brief, I hoped for a people to undergo a sea change in how they think and act together when under sever stress. Listing the stress factors of today may well include full-blown financial repression decimating savers' income as Treasury Bonds and Notes offer miniscule income, massive government intrusion – forget your personal politics – in every aspect of our lives, spawning a further loss of confidence in a government that is rife with scandals, incompetence, self-serving behavior and spending. Lack of leadership abounds and managed media has created a false sense that the crisis, however defined, has lifted . . . the list is long an ugly.

Through it all, Americans have reacted – sometimes with anger, often with action (Tea Party, 99%, etc.) and, of late, with a complacency – a quiet before the "Perfect Storm" – that I think will come when Americans, collectively, hear the "snap" of a twig – that being a widely-noted realization that it's not getting any better in the leadership category from which personal security and hope for the future rise and some outside event drives that home. Perhaps Art Laffer set the stage best:

> *Conservatives believe that the Obama Administration does not have any unifying foreign policy doctrine; that it instead makes foreign policy*

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decisions based upon how the President believes they will effect the domestic policy agenda.

The door is open, if you would, to an outside surprise.

Of course, the sole domestic agenda is well known to the most casual reader – more – more entitlement, more laws, more. In a world of nuclear-armed rogue nations like North Korea, Syria, Iran and soon, Yemen, no defined foreign policy allows events like Benghazi to be passed off as a mistake rather than a reflection of having no foreign policy clearly communicated to the world, least of all to we voters. Let's call it our "Open Door Policy."

Our <u>individual</u> domestic issues, on the other hand, have work-throughs, be they returning home to live with the parents or collecting welfare, we find ways individually to at least try to survive domestically.

This uniquely American survival instinct – energy – talent – whatever it is, will, to my mind, find us converging into a rather powerful voice when some external, non-domestic issue emerges. It will take an emergency, not a voting event, to bring us together. I have every reason to expect that emergency, as the remaining topics will touch on.

My view is that, on an individual level, we are working through our issues and, so focused, are complacent about external issues which we continue to believe "others" will solve. We see, collectively, no global tiger in the bush, hear no twig snapping. I believe that the lack of true leadership at the global level – as it was, for example, with the old Soviet Union and the United States – the cops on their respective beats – is providing a fertile field for the likes of Assad or Kim Jong or others like them.

People, I believe, will coalesce, converge, and then act far quicker than leaders because we are electronically linked as never in history and, frankly, global leaders have too many local hoops to jump through much less be brave in the process. As it has in the past (WWII, the American Revolution, etc.), I believe an emergency will bind us. The stage is being set for a unifying event triggering our convergence, as it did for the Arab Spring, the (insane) Italian election and, well, you get it – high participation attempts by citizens for significant change.

<u>Speed</u>

Digging out of the last 5 years began ever so slowly. There were at least 3 distinct moments when pundits called the Great Recession "over" and made endless errors in the forecasts for "next year's GDP." Through the long healing process here and well ahead of Europe, I have argued that time was the major tool needed for consumers to rebuild both confidence and their balance sheets because QE stimulus simply wasn't going to do it. Political inaction led to no changes in regulatory or tax law; in fact, both increased – and we are adapting to that

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also. Its bottomless nature – its consequences – have yet to truly sink in. Or perhaps we think "they" will solve that also.

Through it all the Fed pumped money into the system – now some $3.2 trillion – by buying debt, generally from banks, with freshly created money. This, of course, fueled the asset markets – stocks, bonds, wine, cars, farms and on and on.

Having created this bizarre buying environment, the Fed was and is ill prepared to slow it down as witnessed by the extreme volatility in the capital markets of late. Mind you, the talk of slowing is all they are suggesting – not quitting cold turkey.

We have, then, Japan adopting a plan that we are talking of slowing. Together, these events are largely causing wider and wider swings, more and more often, as traders and investors simultaneously try to anticipate, trade on and avoid price swings they are themselves creating. I will say it again – investors are trying to simultaneously anticipate, trade on and avoid price swings they are themselves creating . . . and the speed is increasing.

Ironically, there is likely to be no stopping the Fed from continued stimulus anytime this year as we are clearly not in a self-sustaining economic recovery – yet. Notice that I am implying a further shortening of time frames for recovery and an end to QE – I think the Fed is done . . . D.O.N.E. I am neither the first nor the last to think that.

My thought, then, is that financial events will increase in magnitude, occur more often and, ultimately, trigger an intervention by the government in the capital markets. The pressure to protect individual economies, individual countries' world trade positions and, most of all, individual currencies, will rise in coming weeks. Suspended trading, higher margin requirements and the like have been used many times before when competitive spirits grew too exuberant.

The problem is that this is global, not specific to a single place where a local regulatory body could step in. So "he who goes first" stands to suffer the most. The country that acts first and hardest to protect her interests will, I believe, be viewed as most vulnerable – especially to traders. Argentina, a decade back or so, comes to mind. Accordingly, countries are likely once again to take short-term moves to delay any real reform, adding further speed to the ultimate emergency. Faster and faster events will unfold, gaining momentum from nothing but fear – or greed – your choice.

Return of the Kings

In the time of kings, money and credit were created for their benefit only. It's a popular myth that coinage arose from the masses. The masses had little or nothing to do with its creation

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as barter was far more common. Kings accumulated wealth and subsequent power with coinage – gold and silver. There was little logic to accumulating corn or furs to pay soldiers or to store wealth. What coinage a peasant might acquire was buried under a hearthstone – which is why they remained peasants.

So kings became countries with ministers and presidents of various stripes and freedoms and gradually money became the preferred exchange medium, accelerated by the rise of the Industrial Revolution among many other factors such as portability and durability. Various forms of governing bodies – a congress, a parliament, a politburo, controlled money. With that control came economic control, the power to tax and spend. Money – gold and silver – evolved, if that be the word, into fiat money – paper with nothing behind it but faith. (I think of Bitcoin as I write this.)

Until today. Today, in the New Economy, every major economy in the world (we can debate "every") is deeply influenced by that country's Central Bankers – their Federal Reserve Bank, if you will, not its governing bodies. All such Central Bank management is short-term focused and fundamentally reactive to events because, I think, that is the scope of their abilities. Our collective complacency feeds this Central Bank short-term thinking, and by "our," I mean the elected representatives we put in office. All the world conferences, committees and the like mean little or nothing as long-term, hard solutions never come from them and Central Banks, ultimately, only accelerate or slow economic events. Will and Ariel Durant published an 11-volume history (*The Story of Civilization*) and in a slim summary book they led off with this:

> "The men who can manage men, manage the men who only manage things, and the men who can manage money, manage all."

"Can" in the quote doesn't necessarily mean "well."

Telling us they will do "whatever it takes" to put the globe back on track is, as in days of old, the kings telling their subjects, "Follow me, I know what I'm doing."

This time, as noted in Convergence, we no longer have any evidence that they know much of anything at all and we no longer are likely to trust such a plea.

<u>What Business Cycle?</u>

Many, many decades ago, we evolved from an agrarian society to a manufacturing one. In both cases, inventory was always a major issue. Rebalancing too much or too little inventory led to price wars, layoffs and charges of dumping (sound familiar?) until demand and supply came back into rough balance. Manufacturers learned "just in time" supplier and inventory management – and just in time, too, because the game changed radically.

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Today the grand evolutionary process to a New Economy sees (for the moment only) manufacturing giving way to services. In a service-oriented economy, people become the inventory and are rebalanced to reflect demand. Absent meaningful wage gains, people don't spend, of course, and by and large, services (legal, financial, restaurant, etc.) may be postponed – thus we began warehousing people, not car parts.

Unlike prior business cycles, the current one is driven by liquidity – cash and credit – not too many cars or too many refrigerators. Although business is awash in liquidity, the consumer, student loans aside, is definitely not. He is, at best, only slightly less in debt. To my way of thinking, business cycles are now more a situation of consumer liquidity than a warehouse that is over- or under-stocked with goods.

Put another way, very tight inventory management in the manufacturing sector may well exacerbate consumer fear or confidence, but cash on hand drives business cycles as credit growth is widely questioned by consumers. In this place, consumers are acting in concert – convergence has occurred around debt reduction and management and subsequent spending, telling me, for one, convergence can occur when events are powerful enough.

This set of behaviors (stop spending, pay debt) also occurred, by my thinking, far faster than in prior periods when the middle class "carried on" while the poor quickly retrenched. No middle-class recovery this time – only a few percentage points of the population truly was unaffected by the last 7 or so years.

Common Country Goals

It will take far more than European countries' debt struggles to unite the world powers – that is evident. As complacency settles in here, in Europe and in China, the sense of working together is less likely.

I suspect this sense of each country going it alone is becoming more prevalent. We see early signs in the currency wars, the solar-panel dispute between Europe and China and the increase in simple short-term thinking about issues. Most importantly, I believe it encourages our Congress, in particular, to avoid the big, long-term issues and to focus on solving domestic social (or perceived social) issues seeing as how few other countries want to engage in more than their own issues. This renewed emphasis on less important domestic issues gives us new, very vocal factions being created in both the Liberal and Conservative communities. Lack of leadership creates power struggles among what would be bit players any other time.

That, in turn, feeds my first premise: Americans know, viscerally, that out-of-control elected officials are buying future votes by "solving" domestic issues while ignoring the elephant of

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uncontrolled entitlement – to both citizens and business – lest you misread me. Leadership on complex significant issues goes wanting, issues grow and people notice and try to fill the gap.

Demographics

This is a subject well beyond the scope of our current Quarterly, but a few key thoughts:

- A large retirement cycle – boomers – is beginning, or thought to begin, about now;

- With pensions threatened with cuts, personal portfolios (those who even have one) still not back to cost and savings accounts producing no income after inflation, many of these boomers aren't retiring unless forced;

- Boomers – heck – most anyone over 60 or so, simply don't spend like the young – few start families, buy homes, multiple cars, etc. What they do want is to live on what they saved.

In time, the needs of the over-60 and the under-30 converge in frustration – frustrated about their economic security, personal security and the lack of response to basic, promised services like police protection or an honest IRS.

Age, then, for the sake of my convergence thesis, is only a mild factor and only because the frustrations are different from the general population. The wild card is that the older demographic understands consequences and comes to conclusions sooner. The young and the old can easily have and compare the very same experiences; the old, however, have seen consequences while, for the young, it will come later. Later, though, is arriving – fast.

Final Thoughts

So, stocks stumble with QE less a factor, demand for the cleanest shirt in the laundry basket – the dollar – rises with the proposed tapering in QE limiting future supply. A rising dollar keeps interest rates from rising radically (but rise they will) for a bit longer. Events accelerate, countries look inward, the old and the young grow distrustful of near all bodies politic and economic growth, by default, is managed by a very few . . . and academics, no less, who have acknowledged they are "experimenting."

Wall Street will shill whatever sells (except gold) and investors will chase income most any place in spite of being warned of the quality risks.

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Confidence in the Fed is based not on their effectiveness, but on their power to drive assets higher in price. Many know the Fed is the economy – until they aren't – and the vacuum their departure will create will trigger fresh crises.

Woody Brock and Jason Hu, among many others, point out the fallacy of the Keynesian-think now dominating our Fed. They note that government spending – stimulus – can work when it is used for a short time, in small amounts and in a situation where that same government is not up to its unborn ears in debt. Beyond that, it creates far more problems than it solves. We are living that; our economy is in the hands of one academic and, I suspect, one under enormous political pressure. The answers to triggering a new growth cycle remain in the hands of the House and the Senate, not with Ben or his successors:

- ✓ Tax reform
- ✓ Simplified regulatory process
- ✓ Redefinition of the role of national government
- ✓ Existing rules/laws fully enforced

And through it all we continue to heal enough to have a weak economy; we grow, but slowly; we spend a bit faster now for reasons that escape me, and we survive. In a year, earnings will warrant current stock prices. Normal bond interest rates arrive – say 3% to 4% on the 10-year – and cost-push inflation starts driving the Fed to consider tightening. Rates will then go higher, but for now that's a cloudy crystal ball as to time and magnitude – settle for higher. By 2016, we will wonder how we got through it and will likely have had GDP up 4% or so in both prior years, mainly from the never-say-die momentum of the American "just do it" attitude. It will be the exogenous – the non-domestic emergency – that binds us, forces us to converge as a single people, resulting in moving us back to our even higher long-term growth potential. A good chance exists that that unknown event will force us to change some, or even all, of the items checked just above . . . or so it seems to me . . .

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