

INSTITUTIONAL ADVISORS

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THE PENDING BEAR MARKET FOR CENTRAL PLANNING

The most well known feature of independent research is the impartiality derived by not being an underwriter or a stock broker. Less well known is the freedom to be independent of the orthodoxy of interventionist economics.

There are basically two interesting reviews that anybody can do. One is the history of economics, which is essentially the history of ideas. The other is to impartially review financial history and observe the recurring patterns of significant events. There is only one financial history and, despite this, there are a myriad of ideas about it.

The most readily apparent is also critical in our era of increasing financial volatility. This is the linked great asset speculations, with the first one in tangible assets blowing out with the subsequent financial mania blowing out nine years later. As focused in the world's financial centre, the first financial bubble climaxed in London in 1720. Generally occurring twice per century, the example that ended in 1 Qtr. 2000 was the sixth such "new financial era", as they have been described by each generation of enthusiasts.

Anyone who reviews financial history would note that the period between the two asset manias has, in each case, been nine years. The next observation would be that if the senior central bank's ambition was tempered by sound money, it did not shorten the nine-year duration. Going the other way, no matter how reckless the senior central bank has been (the examples of 1720 and 2000 were the most egregious), the duration has not been extended beyond nine years.

All have been followed by a long period of financial and economic contraction that eventually healed the abuse of the credit and currency markets otherwise celebrated as a "new financial era". In some examples, including ours, the third year out from the bubble has recorded a cyclical business recovery and bull market.

One irresistible conclusion is that the financial forces engaged in the paired great asset speculations have been so powerful as to overwhelm policymakers' attempts to materially alter the basic pattern (This would include the old propaganda about "curbing inflation", which reached unprecedented levels in 1980, or then vainly trying to extend the 1990s' financial bubble.) Another is that financial history, itself, is a profound due diligence, not just on the wild promotions integral to every great market speculation, but also on every theory of intervention and its application.

Without appropriate due diligence, the consensus ardently believed that the fabulous prosperity of the 1920s and 1990s, for example, was the result of brilliant policy and that the "new era" was a lasting condition.

While 1 Qtr. 2000 indelibly recorded furious convictions that the tech bubble would continue, 1 Qtr. 2004 recorded similarly intense convictions that U.S. policymakers would depreciate the dollar well into the foreseeable future and that China would continue to buy commodities for the equivalent duration. These were ideal conditions for the biggest "full-court press" on silver since the delusions that drove silver to 48 in 1980.

Beginning with nickel in early January, there has been a series of speculative spikes and severe plunges. Nickel has dropped from 8.05 to 4.95. The run-up in the Baltic Freight Rate ranked with some of the greatest zooms in financial history and, since the high in February, it has fallen 30% to 3900.

Even lead joined the party and spiked up to 44.2 on March 1, from which it has plummeted 29% to 31.5. Suggesting some impetuosity, silver managed the 29% plunge in two weeks plus a day.

These statistics also provide serious and impartial comment on the boom in China, which seems to be paralleled by the Shanghai "B" Stock Index. The high was 123 on February 9, from which the initial drop ended at 114 on March 10. The rebound was to 120 on April 5, from which it has set the downtrend by taking out the initial low of 114. It's now at 105. (Chinese central planners are only now discussing a means to cool their boom.)

These sudden losses of speculative abilities are serious, but this seems not to have daunted the convictions that a senior central bank can depreciate its currency at will.

History suggests that without soaring asset prices, this prerogative can be denied and this typically has occurred following a bubble.

But before developing this theme, it is worth reviewing some of the statements made in the leading economics textbooks and other sources just prior to the collapse of central planning in Communist countries that became magnificent failures in 1989. The first is from outside the 1989 time box and is identified below:

CENTRAL PLANNING CONVICTIONS IN 1989

"It goes without saying that only a planned economy can make intelligent use of all of a people's strength." - ? ?

The private economy is "like a machine without an effective steering wheel."
- Samuelson

"Despite the gargantuan character of the coordination problem, Soviet central planning has worked reasonably well."
- Campbell McConnell
Best Selling Economic Textbook Writer

"Stalin's economic organization was remarkably successful." ¹

- Robert B. Reich, Harvard Professor
then Member of the Clinton Administration

"The real question is not whether we want elements of socialism on planning to abridge our personal freedom, but by how much."

- Textbook Writers: Baumol and Blinder, Princeton

The top statement on central planning was made in the 1930s by Adolf Hitler.

This was also supported by Maynard Keynes, whose preface to the German language edition of *The General Theory of Unemployment* included: "***The theory of aggregate production . . . nevertheless can be much easier adapted to the conditions of the total state than . . . [when] put forth under conditions of free competition.***". ²

Beyond the various theories of intervention, there is the practice.

The notion that some agency can lower interest rates at will dates back to the 1500s. In 1694, this attended the formation of the Bank of England when its promoters claimed that it would "infallibly" lower rates. Instead, interest, which is the measure of the cost of money, continued to fluctuate with high rates during booms and low ones with the *consequent* contractions.

With the maturing of the London financial markets and the Bank of England by the 1740s, the swings in rates for long-dated governments ranged from highs between 5.5% and 2.5%. In every case, the highs were set with high commodity prices associated with the end of a secular expansion.

In the U.S., this was 5.5% in 1920, with the previous secular low set at 2.5% in 1895 with the end of the contraction that followed the 1873 financial bubble. The next secular low came in at 2.20% in 1946 and, in following this pattern, the impartial researcher could have concluded, in real time, that a secular increase lasting for a few decades would be next.

Sure enough, after 1946 rates started to increase and as they approached 3% it became simple arithmetic that the cost of servicing government debt would also go up. Those who studied economic theory rather than financial history claimed that Fed and Treasury buying long treasuries out of the market would infallibly lower interest rates.

Despite the program, rates rose seemingly without much resistance through the fixated level of 3%. Somewhat later and riveted by the distressing prospect of

¹ These conclusions seem not to be based upon a direct examination of Soviet prosperity, but upon the tautology that Russia had authoritarian central planning and therefore the results had to be good.

² Marx was a prodigious reader of history and concluded that totalitarian central planning would solve all social problems. According to Hayek, Keynes was "totally ignorant" of economic as well as market history. Relying then upon his fantastic imagination, Keynes also believed in the totalitarian approach.

Support for interventionism in its varied forms seems to be based upon personally held convictions about what "ought" to happen rather than upon the resolute nature of financial history.

long treasuries rising through 6%, policymakers came up with an elaborate scheme promoted as "Operation Twist".³ Perhaps not sufficiently elaborate or promoted, rates soared to 15% in 1981.

As with any secular high for yields in history, this was associated with a secular high in CPI inflation. The distinction to be emphasized was that it was accomplished at 15% rather than at the 5.5% highs set on five previous secular highs.

The reason that rates almost tripled previous highs was not a curiosity of fate but simply due to a misguided attempt to artificially lower interest rates. Such a prolonged attempt had never been tried before and, of course, chronic currency depreciation added an increasing and ultimately huge premium on interest rates. In the final analysis, bond buyers are not always as benighted as policymakers.

Then eventually the business cycle that peaked in 1990 was the last one of the "old" era of inflation and the collapse of many speculations in tangible assets, as in previous examples, set up our great financial bubble.

Then, as defined by history rather than theory, a long but varied contraction would follow. One of the features is a rapid plunge in short-dated interest rates that only follows a bubble. For example, from 6.25% reached with the 2000 bubble, treasury bill rates plunged to 0.88% early in 2004. Similarly, this rate fell from 5% in 1929 to eventually 0.06%.

The next adventure of policymakers buying treasuries was a blatant attempt to prolong the 1990s' financial mania. The Rubin-Summers Treasury at the height of the speculation in late 1999 and early 2000 was buying treasuries out of the market. This was aggressive and highly publicized.

From the top of the last business cycle (in July, 1990) of the "old" era, our "new" era ran 116 months to the climax in March, 2000. The previous example ran from January, 1920 until September, 1929, or 116 months. So much for that attempt to change financial history.

In at least one instance in the 1870s, the treasury moved to inject cash into the money market by buying long bonds, but this was to stem a severe financial panic. Until recently, the notion that some government agency would inject cash into the raging speculation of 1 Qtr. 2004 would be considered as madness.

This essay is a little late in arguing that the Commodities-China boom would blow out by March. (This was covered in the address to the World Outlook

³ In the first half of 2003, officialdom hyped the bond market with the notion that the Fed and Treasury could "peg" long rates at 2 ½ %. According to today's theoreticians, their predecessors "pegged" interest rates at 2 ½ % in the 1940s.

In May-June, we considered this as equal parts of ignorance and arrogance. Based upon this and technical analysis, we provided the "sell" on long treasuries close to the top. It was followed by one of the six worst plunges in government bonds in the senior currency since 1720.

Conference on February 7, which can be reviewed in our website.) However, the intention is to place in perspective the still vibrant conviction that the recent setback is only temporary and the Fed will soon get the dollar depreciation going again and the Chinese boom will continue its dynamism.

Again, it is appropriate to refer to recent examples of intense but unsound convictions that policymakers can artificially alter interest rates.

By their name, financial bubbles are not limited to equities. An essential feature of the post-inflation era is the rush to buy yield without regard for risk. The measure of this is the confidence of narrowing of credit spreads.

While it is common to bubbles, those who are immersed in theory have to supply a cause or reason for a natural event. In 1998, it was the anticipation that officialdom would narrow the spreads of interest rates for the vastly different countries of Europe. In theory, this would be achieved by the advent of a common central bank with a common currency. With the implied budgetary discipline, interest rates would approach similar levels for the still different countries.

The game to narrow spreads was called "convergence" and it was intensely believed. LTCM and its supporting central banks fell for it – literally. During the mania, anyone sceptical of great market, or even theoretical, convictions would have done their due diligence on this nonsense.

Of course, the comparison was that during the "iron" discipline of the gold standard era, there was a vast difference in interest rates for the different countries of Europe. If spreads didn't "converge" on that formidable budgetary discipline, it couldn't be expected to work under the whimsical discipline of a soft currency such as the euro.

The last one hundred years has seen the greatest attempt by government or their agencies to alter financial history in, well, financial history.

This brief review is limited to the most obvious series of blunders and does not cover the excesses committed by the Fed in the 1920s' attempt to restore pricing power to agriculture and industry. That blunder, as many know, was concisely covered by Alan Greenspan in his essays of 1966.

Instead, these pages are limited to the attempts to alter the natural course of interest rates since the folly of preventing rates from rising above 3%.

The latest revival of speculative furies has been a possibility in the third year after the collapse of a bubble and should not be considered as a result of aggressive policymaking. Indeed, as this essay is being completed, the nemesis of interventionism is again becoming forceful. Both financial and tangible assets seriously declined in price as the dollar strengthened. To be brutal, the only thing that central bankers can do and have done is to depreciate their currency. And that has been limited or prevented in previous post-mania contractions.

With the rising dollar so far, this is being thwarted. (the dollar index is becoming overbought close to our target of 91.8.) So it's worth reviewing the speculative spikes and collapses that began with nickel in January and encompassing silver a few weeks ago. The progress from spike to collapse has been relentless and the dispassionate question is – what speculations are still on and therefore eligible to be next in the series?

The most immediate bubble of conviction is the "best earnings season in ages!". For decades, S&P earnings have gone up and down with base metal prices and this conviction is now vulnerable.

Admittedly, this earnings bubble mentality will only shrink slowly, but more immediate drama could be seen in the only remaining sure things. These would be the stock market, which is rolling over, and credit spreads, which have seen only a modest pause in highly speculative convictions. Downside drama is next for both.

One of the most unique speculations in financial history has been leveraged upon collapsing short rates, which has been a signature of a post-bubble contraction. Shortly after 9/11, the public started what we have called speculative consumption of grand cars and median homes. The hype has been "zero-cost" car loans and low mortgages. The two-year note has soared from 1.47% on March 24 to 2.32%. An 85 bps jump renders discussion of a change in administered rates redundant. The "carry" trade needs little influence from the Fed to range from "manic" to "dismay".

As the last of the manias fail, it will leave only one conviction remaining and that is that policymakers managed the recovery and that it can be maintained. Or, to be blunt, they can continue to trash the dollar..

Instead, and as in Communist countries in the 1980s, the impracticality of the theories and practice of central planning will come under critical scrutiny. Eventually the conclusions will be that generations of financial adventurers in public policy, in collusion with ambitious politicians, used a scam to accomplish an unprecedented transfer of power and earnings from the economically productive to the predatory state.

One of the greatest political reformations since the 1600s started in the 1980s when hitherto submissive citizens in Eastern Europe reacted against their monopolistic governments. And those with an independent mind set will soon realize that all it will take to place Western central planners in a similar perspective is a contraction in overly inflated tangible and financial asset prices.

Some are expecting a disaster for the senior currency. Quite likely, rather than the dollar being repudiated, the management of it will be repudiated. This would effectively end the *Federales'* monopoly on the dollar and the monopoly of depreciation.

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