MAI VIEW

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Being Here

"As long as the roots are not severed, all is well. And all will be well in the garden."

- Chauncey Gardner (Chance, the Gardner)[1]

This piece takes a roundhouse swing at politics, real and imagined, and discusses critical economic issues that politicians should actually apply a little intelligence to, but are not. Capitalism will ultimately set things right, but it will have to overcome the political dimension's best efforts to ignore real issues.

The Real Deal

An important character trait for wealth creation today seems to be incuriosity – find out what's working, hop on board, enjoy the ride and don't ask questions. Growth and value metrics seem to matter less than they used to, and so investors have turned their gaze to macroeconomics and, gulp, politics.

We think investment-related political discussions that handicap the likelihood of new pro-growth fiscal, tax, trade and regulatory policies in the US are off-base and have taken on too much importance. They do not promise *sustainable support* for the US economy or markets given a few twenty-first century realities:

- Full value: the scale of financial markets has already become quite big relative to output.
- Financial asset price appreciation now reflects a) short-term balance sheet management and b) price deflationary innovation, rather than growth in the sustainable capital stock.
- There is no longer such a thing as a domestic economy, even if economic initiatives help shift domestic investment and consumption. Global goods and service prices, and trade responses from well-organized foreign economies, tend to quickly offset domestic stimulus programs.

Late cycle economic initiatives, such as those discussed by Mr. Trump, are ultimately derivative of waning animal spirits. They can be distorted for a time by credit policies and legislation, but they cannot be kept permanently in disequilibrium. Human incentives, along with innovation, productivity and balance sheet digestion, tend to overwhelm the best efforts of policy makers trying to extend trends. After a generation of pulling credit and revenues forward, culminating in rock-bottom borrowing costs; lower taxes, (deficit-funded) government investment and reduced regulatory oversight would be only marginally stimulative.

The combination of ubiquitous leverage, aging Western wealth holders, and deflationary globalization and innovation (including non-sovereign distributed ledgers that allow value to be transferred directly among willing counterparties anywhere across the world), pose the biggest threats to traditional domestic output and inflation models still embraced by global economic policymakers and most investors.

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[1] Being There; Jerzy Kosinski; 1979; BSB.

This sets up an epic global economic battle if Americans choose to keep US nation-state sovereignty, which of course they will. It is serious stuff that will require serious leadership and diplomatic skills from the President of the United States, which, as the global hegemon, has the most to lose.

Fake Politics

It should not surprise anyone that Western societies are becoming restless. Trump, Brexit, Charlottesville and, arguably, even radical Islamic terrorism are bi-products of global economic distortions largely created by the unwillingness of the Western political dimension to let the global factors of production naturally settle global prices and wages. (Sorry, it had to be said.)

Donald Trump is a sideshow. His ascension, or someone like him, was inevitable. He may have official authority to behave like the leader of the free world (even if he is unable to do so), but so far he has only shown that virtually anyone can become president. Indeed, one might say Mr. Trump represents a triumph of democracy. Behold the robustness of America: the most powerful nation on Earth is unafraid to elect a cross between P.T. Barnum and Chauncey Gardner!

This is not to say a US president cannot raise and emphasize truly meaningful economic goals and mobilize countries around the world to help achieve them; but it is to say that this President seems to not know or be interested in what those goals might be.

As discussed, the biggest challenges facing the US economy and US labor stem from a distorted global price and wage scale. Mr. Trump's domestic fiscal, regulatory, tax and immigration goals seek only to raise US output and wages. This cannot be achieved without the participation of global commerce. There is no such thing anymore as a US business that makes US products sold only in the US without being influenced by global prices, wages and exchange rates. The romantic, patriotic "made in the USA" theme does not comport with the reality that the US also seeks to keep the dollar the world's reserve currency and that maintaining America's power requires the US to control the world's shipping lanes. Mr. Trump and his base cannot have one without the other. (Do we really have to articulate this?)

Mr. Trump's "Being There" presidency is reflecting an inconvenient truth back on a society that has, until maybe now, successfully deluded itself into believing government is functionally the glue holding society together. Though he does not mean to, Mr. Trump is single-handedly demonstrating to groups ranging from idealistic Washington elites to social media zombies to southern white supremacists that Madisonian government has become a dignified cover for the financial, commercial and national security interests that control it. We suspect those interests would rather the reach of their power be less visible.

For the more pragmatic among us, Mr. Trump's bravado and apparent emotional instability have created the need for a public work-around. He remains tentatively safe to wealth holders because he hired Goldman Sachs to manage financial affairs, and acceptable to globalists because he is deferring foreign policy to the NSC (i.e., "the generals"). Mr. Trump may continue to speak in nationalistic terms, tweet IEDs, and confound media used to personalizing policy; but it seems highly unlikely he will be able to make high yielding unilateral policy decisions. He will likely settle into a pattern of lobbing increasingly ignored tape bombs and hosting elegant state dinners, as an insane king might. Or else, he will be out.

Just as the virtuous Carter followed the vice-ridden Nixon and the strapping Clinton followed the crusty Bush 41, the vulgar Trump predictably followed the cool Obama. Donald Trump is a man-in-full (of himself), and so we would not be surprised if the next president is an empty suit. (We are unsure how literal that can be.) Given our view of the extraordinary structural changes about to impact US and global economies and societies, the most attractive feature for the next presidential could be a really intelligent person who says "I don't know" fifty times every stump speech. We are ready to vote for a thirty five year-old woman who can code, if only because the president of the US must be at least 35.

The differences separating political platforms are beginning to matter less than they used to. The billions spent in election cycles and beyond accomplishes little except redistributing liquidity from sentimental or idealistic savers from both parties to media company executives and their shareholders. None of it reduces the leverage on the balance sheets of global governments, households and businesses, or starts a conversation about how to reconcile rising asset prices and falling wages in a digital global economy.

Manifestations

At the risk of oversimplifying, the *tension between globalization and nationalism* has the greatest influence on economic, social and political affairs today. We were reminded of this last week watching Donald Trump channel the misplaced angst and anger of hate groups, mostly displaced and disaffected white men who have been caught directly in the crossfire of efficient global resource distribution.

One need only observe life to understand the game-changing economic impact of globalization:

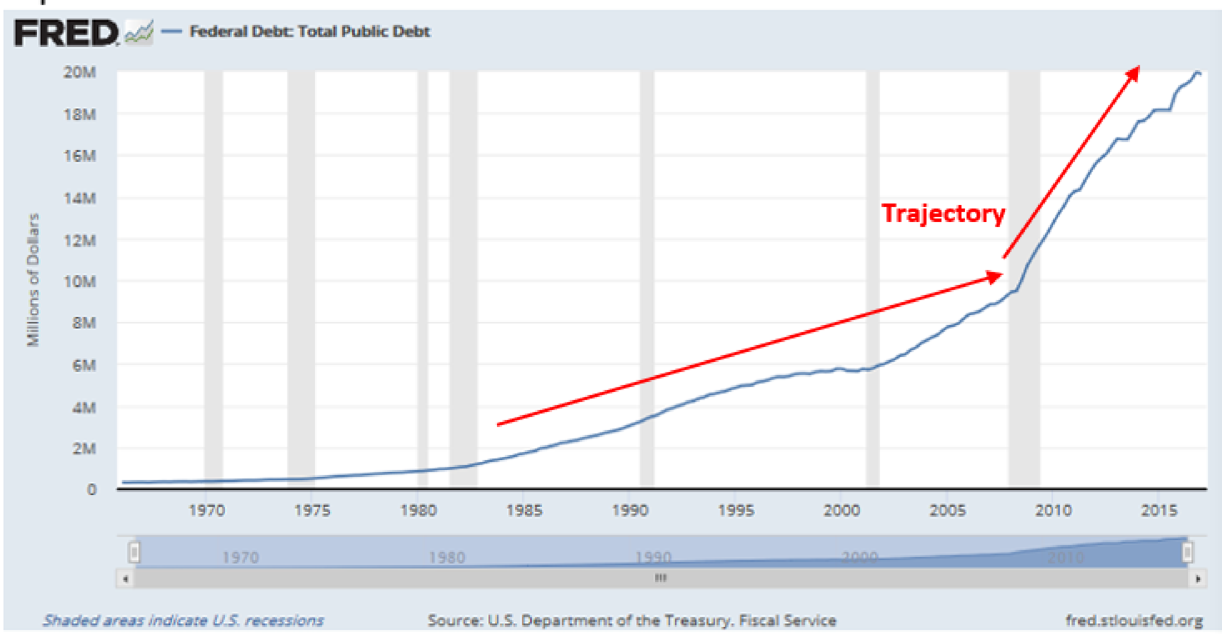
- the opening of Chinese and Soviet-bloc economies in the 1990s;
- trade treaties that created jobs and drove wages higher in developing economies and displaced jobs and drove real wages lower in developed economies;
- innovation and technologies that reduced price inefficiencies and displaced workers;
- ubiquitous real-time direct connectivity across the world;
- an anachronistic, policy-driven global economic system, comprised and coordinated by sovereign politicians, trade representatives and central bankers, that *talk domestic but act global*.

The disconnection and underlying hypocrisy are obvious to anyone trying to understand increasing social unrest around the world. National and global economies meant to follow a mostly capitalist outline contrived and administered by policymakers, rather than one following free-market incentives, can last only until late-cycle policies become ineffectual and superfluous.

This is occurring now. *Consider that wealth is no longer created from production, but rather from financial pricing models and credit creation, credit that must increase at a parabolic pace and can never be extinguished without substantial output contraction and rising unemployment. It cannot last indefinitely.*

Central bank purchases and government investment have been fabricating output growth and asset gains. Central banks now hold about $19 trillion in assets on their balance sheets, up from almost zero in 2008, and are now 20 percent owners of global assets. There is also about $20 trillion in US federal debt, up from $9 trillion in 2008. (See debt growth trajectories in Graph 1, below.)

Graph 1: US Federal Debt



Source: St. Louis Fed.

Stocks, bonds and real estate collateralize each other while output growth makes it possible to service debt. It is not a stretch to assume that output and asset prices would have fallen without government and central bank subsidies, and that they will fall in the future if/when global central banks withdraw support.

Print Money, Get Rich!

Hey passive investors, you're not that smart…unless your calculus has been to front-run the insecurities of elected and appointed officials who would reliably be unable to sit on their hands while economies and markets correct, rather than bending economic and asset space/time continua to perpetuate positive trends (and their careers).

The reality is that real (inflation-adjusted) returns for long-term holders of financial assets cannot be calculated yet. Deflating nominal returns using coincident goods and service inflation measures (e.g. CPI, PCE) compares apples to oranges – asset price changes vs. consumer price changes. It works if you want to know if you could have cashed in your assets and bought a basket of goods and services, but not if you want to know if you will be able to cash them in and then save risk-free in the future (i.e., create wealth).

The problem is that there are too few dollars for each claim on dollars (credit). The credit that collateralizes equity cannot be repaid and, if output declines, cannot be serviced without more credit. Equity and credit prices will fall (deflate) in tandem as debt service and repayment declines, unless more dollars are created *and floated to asset holders*. This is the process of inflation, and the pace of this, not consumer inflation, is what should be used to deflate nominal asset returns.

The current imbalance separating credit (claims on money) from money itself suggests a doubling, tripling or even quadrupling of the money supply <u>*in float*</u> *(yes, 100, 200 or 300 percent monetary inflation directed towards financial markets). This implies nominal asset prices could rise, but not nearly as much as the purchasing power value of the currency they are denominated in would fall.*

We doubt all the new money could be distributed to the investor class and then reinvested back into financial markets, and so we think it is highly likely that nominal equity and debt prices will fall markedly in the future, though we cannot know from what level.

If you have suspected that it has been too easy to get rich by simply *being here* and investing passively in popular markets, you are right in our humble opinion. To realize gains, most investors will have to cash out their assets and then exchange that cash for money that will not be diluted. It is a mathematical impossibility because: 1) the money does not exist, and 2) by definition, most investors cannot time the market. We doubt any of this will be discussed or debated on the campaign stump…or at Jackson Hole.

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