Bauerle's Bank Notes

Debasement

August 4, 2014

In the year 2000, Sun Microsystems Co-founder Bill Joy said the vortex of technological transformation is most difficult to understand when one is in the middle of it. His remark came to mind last week as I read an opinion piece in the Financial Times titled, "Fear of Bubbles Hides Risk of Stagnation." Author Robin Harding weighed the wisdom and effectiveness of the easy money policy pursued by the Federal Reserve Board of Governors since the turn of the century with only a brief interruption when the economy strengthened in the period 2004-07. With the dollar not linked to gold since the early 1970's, the Fed has debased the currency by prolific issuance and has bought U.S. bonds swelling its balance sheet to $4 trillion.

Harding notes the widely held view that this policy is dangerous both as a cause of the housing bubble of the last decade and as it increases the risk of destabilizing levels of inflation and reckless speculation on asset prices in the current moment. At particular risk, according to a recent OCC paper, are banks that have bet long and wrong on the persistence of low interests rates. In other words, the road to ruin is paved with the Greenspan Put, the Bernancke Put and Janet Yellin's "dovish" stance (she has yet to have a put named for her). According to Harding,

> Another disquieting scenario is the "secular stagnation" hypothesis put forward by Lawrence Summers. He suggests that the relationship between interest rates and output may have changed permanently. Whatever the underlying cause, whether it be greater income inequality or the mercantilist policies of China, this would mean significantly lower interest rates are needed to keep the economy at full employment. Again, that would imply high asset prices and permanently lower returns.

The evidence to support both theories shows up daily as we receive e-mail announcements from private equity funds touting sub-teen returns on investments being sold (what happened to >20% returns?) and begging for new assets in which to invest. There is simply too much money chasing too few worthwhile deals. Bankers say so; so do deal sponsors. But as Chuck Prince of Citigroup said about the origin of the subprime crisis, "As long as the music is playing, you have to get up and dance." So they do until their legs (i.e., their capital accounts) give out.

Harding's conclusion is chastening:

Some markets, such as high-yield debt and London property, do look frothy. The crucial thing is that high asset prices not be compounded with growth in debt. That means making macroprudential policy work. The Fed has tried to crack down on leveraged loans but so far the party continues. It needs to do more.

There are also implications for investors. In a bubble, the correct thing to do is steer clear, wait for it to burst, and then invest with the prospect of better returns. But if there is no bubble then returns will not improve. Investors will need to ponder how they can reach their financial objectives despite them-which probably means saving more.

Bubbles are frightening. But constant warnings about them are distracting people from the real danger: that investment returns will not be high enough to meet their needs. If the reality turns out to be secular stagnation, we may envy the day when all we worried about was the risk that the bubble could pop.

In our view, understanding and addressing the Hobson's choice Harding presents requires examining technology's continuing transformation of the economy, including banking. For perspective, I recently reread <u>The Railway Journey: The Industrialization of Time and Space in the 19th Century</u>. A mid-1970's study of technological transformation, this monograph by German scholar Wolfgang Schivelbusch not only chronicles the impact of emerging technologies like the railroad and telegraph, but contrasts Europeans' and Americans' experiences with them. In Europe, he says, railroads were a disruptive technology that forced people to reframe their experience of place and time. The experience of place was simultaneously expanded via greater accessibility and contracted via greater familiarity and economic and social integration. Think German unification under Bismark.

In the United States, railroads were a liberating technology that allowed a small population to conquer a new (to them) and large continent, radically increase their prosperity, and establish political and economic hegemony. In Europe, labor was plentiful but tangible assets like land were scarce. In the U.S., the opposite was true. In both locales, this influenced how and where railroads were constructed. Although Schivelbusch doesn't say it, capital too was plentiful in Europe but not in the U.S., necessitating Junius Morgan (father of J.P.) and other U.S. bankers' going to London and Berlin to fund U.S. railroad construction. Many parallels can be found to how computer technology is currently being integrated in developed and developing economies (e.g., Brazil, Russia, India and China). Space constraints prevent our exploring them here. Several takeaways are worth mentioning however, especially in relation to the banking economy.

1. <u>The value of labor continues to be debased by technology</u> in both the manufacturing and non-manufacturing sectors of our economy. Compared to people, machines are less expensive, more accurate, more reliable and more efficient. Branch banking as we knew it is obsolete. Wholesale banking has migrated offshore as U.S. companies denude our

nation's goods-producing economy and keep their cash balances offshore as well. Technology offers promises and peril in the same way that railroads simultaneously expanded and contracted Europeans' sense of place. As machines replace people, there is less reason to send work offshore to capture low-wage production economies. Yet there is also less need to hire U.S. employees because machines are preferred. So the population of skilled and unskilled wage and salary earners continues to experience economic dislocation.

2. Wage inflation remains nonexistent while companies struggle to attain pricing power. In late 19th Century America, corporate announcements of wage cuts and resulting employee strikes were commonplace. Pennsylvania Railroad workers burned down a section of Pittsburgh in 1877 in just such an event. The railroad's president recommended the strikers "be given a rifle diet for a few days and see how they like that kind of bread." Forty-five days after it started, and only after President Hayes sent in federal troops, the strike ended. Occupy Wall Street is today's version. People's sense of economic insecurity shapes elections and many other behaviors, including the lowest loan to deposit ratio at American banks since the mid-20th Century. The new CEO of Microsoft told employees two weeks ago that their industry has zero respect for tradition, and he's right; layoff of 14% of the workforce followed. The availability of inexpensive manufactured goods from Asia and Third World nations mutes the household burden of growing income disparity. What remains is the psychic burden of economic vulnerability, which manifests itself in social and political behaviors on which both political parties seek to capitalize.

3. Banks can't win by waiting it out on the high ground. Banks today face an unenviable choice between booking loans or buying bonds, too few of which in either asset class are priced to reflect the embedded risk. On cash they earn 25 bps at the Fed. They understand the dilemma but are hard pressed to overcome it. The challenge is to make thoughtful bets on companies, and managements, that stand to gain the most from the changes that are afoot. Identifying them, as Bill Joy said, is no mean feat. It requires getting down off the mountain into the valley and doing the hard work of assessing people, businesses and opportunities the old fashioned way. It also requires the courage to walk away when the return is not worth the risk.

History will settle whether the Fed's easy money policy will be an effective antidote to the technology-driven changes underway in our economy, both nationally and internationally. The only constant is change, as the old saw says. We all understand we live in the grip of changes as radical as those of the Industrial Revolution. How well we adapt ourselves and our institutions will be the measure of our survival and success.