

October 2010: Surviving Our Minsky Moment

By John Goltermann, CFA, CPA

This commentary builds on our fall edition of *Obermeyer News* (included in the 3rd quarter client statement packets). We want to further explore how a period of prosperity, combined with political incentives, led to excessive leverage and, in turn, how it has altered the risk-opportunity set in the wake of our Minsky moment.

Hyman Minsky, an American economist, wrote extensively about the relationship between financial market fragility and speculative bubbles fueled by excessive credit creation.¹ Periods of relative financial market stability, Minsky felt, engender complacency. This complacency in turn fuels new debt creation: because incomes far exceed existing debt service costs, there is a willingness and ability to take on more debt. A speculative euphoria inevitably develops, culminating in a Minsky moment (a term coined by Paul McCulley of PIMCO).

Minsky saw borrowers as falling into one of three categories: 1) Hedge borrowers, who pay principal *and* interest on their debt through their investments' cash flow; 2) Speculative borrowers, who can *only* pay interest on their debt from their cash flow, but must regularly refinance the principal on serviceable terms; *or* 3) Ponzi borrowers, who rely on asset appreciation to pay principal *and* interest. Only rising asset prices can keep the Ponzi borrower afloat.

If Ponzi finance becomes too widely adopted, asset prices inevitably stop increasing because Ponzi finance is itself unsustainable. All borrowers then find themselves without credit availability and the whole system seizes up. The U.S.'s Minsky moment occurred in 2008.

Minsky argued that we need governments to prevent the widespread development of Ponzi finance. Sensible regulation and central bank policy should counteract human beings' inherent pro-cyclical (momentum investing) tendencies. In other words, behavior needs to be kept in check by policies that prevent us from harming ourselves and *systemic stability should be promoted to prevent speculative euphorias from developing in the first place.*

In the United States, not only were these precautions not in place, but the government and the central bank (the Federal Reserve) adopted policies to actually encourage Ponzi finance and to promote speculative bubbles. Alan Greenspan, in a speech to the Credit Union National Association on February 23, 2004 said the following:

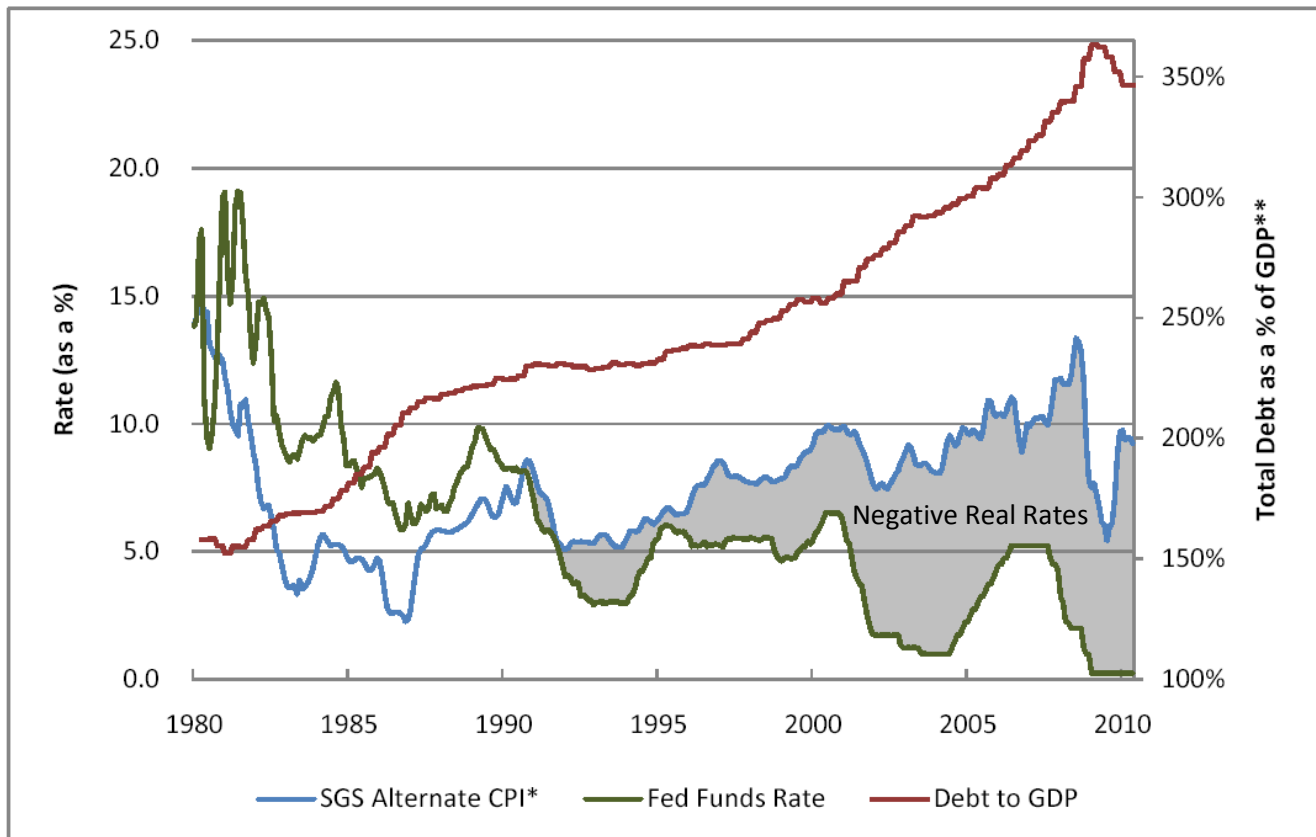
American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage. To the degree

¹ Hyman Minsky and his economic theories are also discussed in *Crisis Economics*, one of the books we reviewed in this quarter's newsletter.

that households are driven by fears of payment shocks but are willing to manage their own interest rate risks, the traditional fixed-rate mortgage may be an expensive method of financing a home.

This was an *explicit* recommendation to the mortgage finance industry to innovate new structures and loan programs and an *implicit* nod to mortgagors (borrowers) that interest rates were not likely to go up.

The chart below shows the relationship between government policy (holding interest rates below the approximate rate of increase in the cost of living²) and the last two decades' skyrocketing debt levels. There were other factors that incentivized credit creation, but an underpriced Fed Funds rate played a significant role (for more on this, please refer to our May 2009 commentary, *Bubble-nomics*).



* Shadow Government Statistics.

**Source: FreeLunch.com.

As the chart shows, *real* rates (after-inflation rates) were essentially held at negative levels for two decades (and still are). This forces capital to chase speculative returns because rates offered on low-risk instruments are insufficient to cover increases in the cost of living.

² As an aside, the SGS alternate CPI (inflation) numbers are calculated by Shadow Government Statistics, an organization dedicated to unwinding the deliberate obfuscation of data produced by government agencies.

After the U.S. had its 2008 Minsky moment, the policy response was to drive interest rates to zero in an effort to continue propping up asset prices and save the big banks at all costs. Now, two years later, the Fed is talking about buying a trillion dollars in new Treasury bonds to juice the economy. This is tantamount to printing money.

In effect, this is a deliberate policy to debase the U.S. dollar. It is rationalized under the theory that we are in a deflationary environment. But is this really the case? What is deflating besides house prices, which were in a speculative bubble?

The problem with printing money is that it doesn't create wealth – it simply transfers wealth from creditors to debtors and from consumers to producers. Further, not all price increases happen in lockstep (i.e., at the same rate and at the same time). Prices on goods most difficult to produce and deliver will likely increase the most.

If we attempt to transfer wealth from creditors to debtors by devaluing the dollar (and by devaluing their bonds and encouraging inflation), many people are going to get hurt. An even bigger problem is that more than half of our creditors are our foreign trading partners that provide us with much needed capital. Without them, our economy ceases to function.

Printed money may benefit the top of the finance industry's food chain – big banks, hedge funds, and the people who run them. But it probably won't find its way into the pocket of the average American. This additional liquidity will likely boost prices of commodities and certain speculative assets and will also find its way overseas, where the investment returns are more attractive and currencies are undervalued. This will likely lead to continued U.S. wage stagnation and a surge in the cost of living.

Our financial system is not structured to promote stability and to handle natural boom and bust cycles. Instead, it is structured to promote booms (encourage borrowing and speculation), then punish the boom's facilitators (lenders) by encouraging inflation and punish the bailer-outers of the wreckage (the taxpayers) by committing their funds when banks speculate excessively.

Given the U.S. dollar's current status as the world's reserve currency, this policy has thus far worked without destroying our system of credit. But it won't work forever because sophisticated lenders and bond investors see the problems, see the structures and see that these perverse incentives are unsustainable. Government policy over the last twenty years has, in effect, abused the privilege of the dollar being the world's reserve currency. This privilege was earned through two world wars, generations of toil and sacrifice and a culture of enterprise combined with fiscal austerity.

When a government tries to debase its own currency, eventually it will be successful. When it insists that we are in a deflationary environment and that we must to do everything in our power to fight deflation, deflation will end. But governments should be careful what they wish for. Let's examine how the current "deflation" and its policy response have affected commodity prices.

The following are year-over-year percentage price increases through September 30, 2010:

Agricultural Raw Materials	24%
Industrial Inputs Index	25%
Metals Price Index	26%
Coffee	45%
Barley	32%
Oranges	35%
Beef	23%
Pork	68%
Salmon	30%
Sugar	24%
Wool	20%
Cotton	40%
Palm Oil	26%
Hides	25%
Rubber	62%
Iron Ore	103%

Source: Benson's Economic and Market Trends.

Will stimulus and money printing be great for the U.S. economy over the long term? Of course it won't. There have been huge amounts of stimulus and money printing since 2000, and the economy is in far worse shape now than it was then. It *has* been great, however, for commodity producers and emerging markets' economies, businesses and citizens. It has also been great for hedge fund principals and Wall Street executives who benefit from excessive speculation. It is likely that this will continue until the leverage is reduced and/or the U.S. gets serious about fiscal deficits and monetary policy. We can't know for sure the path this takes through financial markets, but it is likely to be painful for the unprepared.

Society's instinct is to protect against the most recent thing that went wrong. We see this with government policy, we see this in the investment industry in general and in the preferences of individual investors themselves. This is why the 10-year Treasury trades with a 2.39% yield! Obermeyer Asset Management, however, wants to be prepared for the *next* crisis, and that is a world of competitive currency devaluations, an increasing risk of outright trade protectionism, decreasing creditworthiness of the U.S. government, growing skepticism of Fed independence and future scarcities across the commodities complex.

The good news for our valued clients is this: capital can be invested to offset the negative effects of bad policies. We can learn from Minsky about the potential negative consequences of excessive credit creation. The Obermeyer investment committee feels strongly that risks can be managed and hedges can be built into portfolios so that investors can position to maintain their standard of living in a potentially stagflationary environment. Moreover, if one has tolerance for some volatility, *positive* real returns can be earned.

Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels. Certain portions of our newsletter may contain discussions of recommendations as of a specific prior date. Due to various factors, including changing market conditions, such discussions may no longer be reflective of current positions or recommendations. Information included herein should not be construed as the receipt of, or a substitute for, personalized individual advice. A copy of our current written disclosure statement discussing our business operations, services, and fees is available upon written request.