# 2010 Year in Review:
# Fugly Gives Way to Muddling

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## Background

Every December I write a Year in Review. Last year's was entitled, *30 Years of Investing from the Cheap Seats* [1] and posted at Jesse's *Cafe Americain*. It provided personal context not to be repeated here, looked back over 30 turbulent years of investing, and attempted to look forward. To my surprise, emails poured in from money managers and investors, including some that would legitimately be called Masters of the Universe. This year's is similar with redundancy avoided where possible. It opens with a highly personalized survey of my own efforts to get through another turbulent year en route to a stable retirement. This is followed by a brief update of what is now a 31-year quest for a soft landing. I conclude with a snapshot of thoughts and ideas that are currently on my radar. The view is somber, bordering on pessimistic. The commentary is largely stream-of-consciousness from memory with minimal references or documentation. The PDF format eliminates hotlinks; references cited in brackets afford access to the most determined reader(s). Although attempting to imitate Will Rogers and Mark Twain, it is probably more Andy Kaufman and Sam Kinison.

This year's survey describes a transition from fugly, which certainly describes 2008, to what John Mauldin (and now everybody else on the planet) calls a muddle. We muddled through the inflationary 70s, the deflationary 30s, several world wars, a civil war, and a revolutionary war. Shards of the Roman Empire muddled deep into the Middle Ages despite some intense M&A activity beginning in the 5th century. And, of course, Europe muddled through the Middle Ages. We will certainly muddle through this mess too.

There are a lot of questions requiring answers up front. Why do I summarize the year? Why should you read a blog from a rank amateur with a 'tude?

Why should any of us pay attention to all this financial baloney when there are professionals to do this for us? I summarize each year quite simply because my views are extreme. My investments have rarely been diversified. I simply don't buy the model that you should own pieces of garbage simply to check all the boxes. I also became a devout follower of Austrian economics starting in the late 90s, which, at the time, was on a par with joining NAMBLA. I must ensure that being a wingnut is not undermining my financial stability. As to why *you* might wish to keep reading I have several arguments. Whatever it is I am doing has worked remarkably well. In 31 years I had only *one* year in which my total wealth decreased in nominal dollars. (Peek ahead to Figure 3 if you wish.) In addition, any economist will tell you that when the free market fails a black market emerges. The blogs are the black market of information. Noted economist Russ Roberts once asserted that reading five blogs is probably better than going to an economics lecture. The blogs, in conjunction with a serious filter, protect you from those who traffic in financial products and misinformation. I ride the blogs pretty hard and am pretty good at distilling complexity down to the extracts of beets and carrots. I should add that the best—the guy who saw this whole mess coming years ago and wrote about the coming problems in all their splendor—is Doug Noland of the Prudent Bear Fund. Doug, you are a genius and my hero.

**Investing**

**My Year in Review.** With rebalancing achieved by directing my savings, I changed almost nothing in my portfolio year over year. The allocations as of 12/31/10 were as follows:

precious metals et al.: 52%
energy: 15%
cash equiv (short duration): 32%
other: 1%

An overall return on investment of 25% compares favorably with the S&P 500 (13%) and Berkshire Hathaway (21%). Precious metals (largely CEF, FSAGX, and physical metals) put up some stellar numbers (Figure 1) owing to gains in gold

(28%), silver (81%), and the XAU (34%). (SLV, GLD, and XAU are used illustratively.) A basket of Fidelity-based energy funds showed more moderate performance. These are represented emblematically by the XLE spider (19%) and XNG Amex natural gas index (11%) in Figure 2. I keep adding to an already chunky position in natural gas equities for reasons discussed below. These results were attenuated by the cash (0.000…%). In addition to the 25% ROI, personal savings equivalent to 33% of my gross income added a couple more percent.

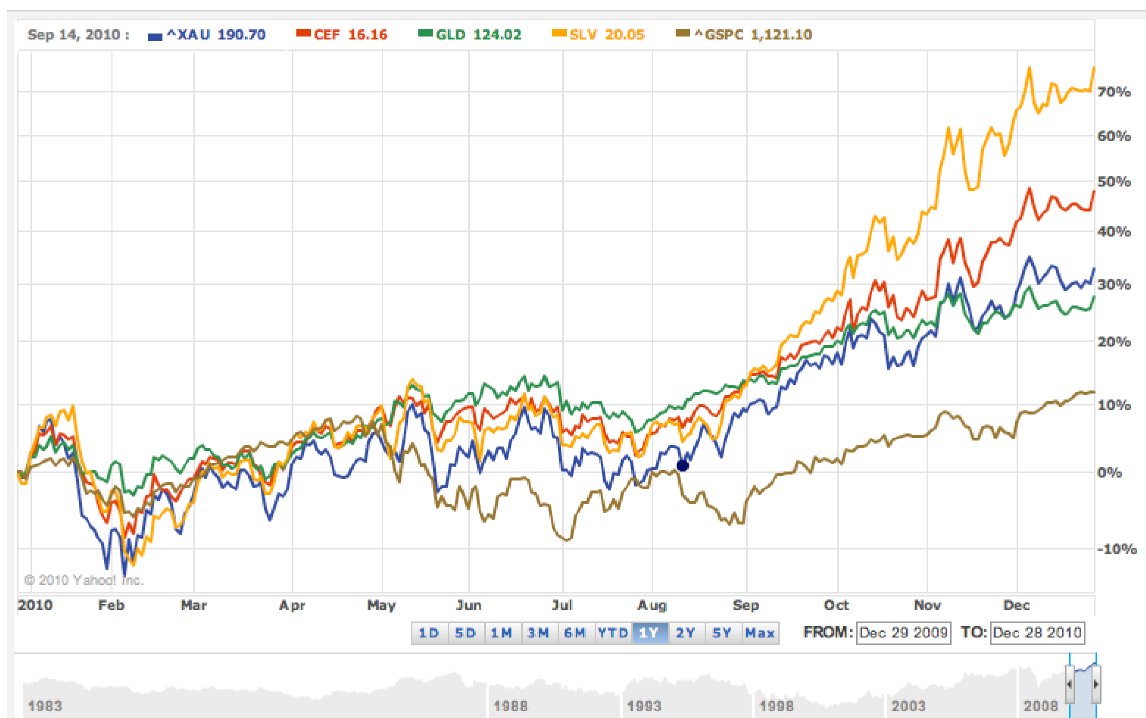


Figure 1. Precious metal-based indices (CEF in red, XAU in blue, SLV in yellow, and GLD in green) versus the S&P 500 (in brown) for 2010.

Figure 2. Energy-based indices (XLE in red and XNG in blue) versus the S&P 500 (in green) for 2010.

**31 Years in Review.** You've got to make a really good call about once a decade to make money in this game. My imbalanced portfolio changed in decadal rhythms as follows:

> 1980-88: nothing but bonds (100%)
> 1988-99: a classic 60:40 equities:bonds (approx)
> 1999-2001: cash, precious metals, some shorts (BEARX)
> 2001-2010: cash, precious metals, and energy-based equities

My total wealth accumulated through a combination of savings and investment as shown in Figure 3. (I blocked out the absolute dollars.) Completely avoiding equity crashes in 1987 and 2000 certainly proved helpful. Aggressively anticipating the bull market in precious metals was a game changer. You can see that 2008 was the only down year, which must be a record. (Buffett/Berkshire had four down years from 1991 to the present.) Year 2000 would also have been

down for me owing to gold's poor performance in its last year of the secular bear market if not for a one-time windfall gain (an "item") that lifted the year into the black.

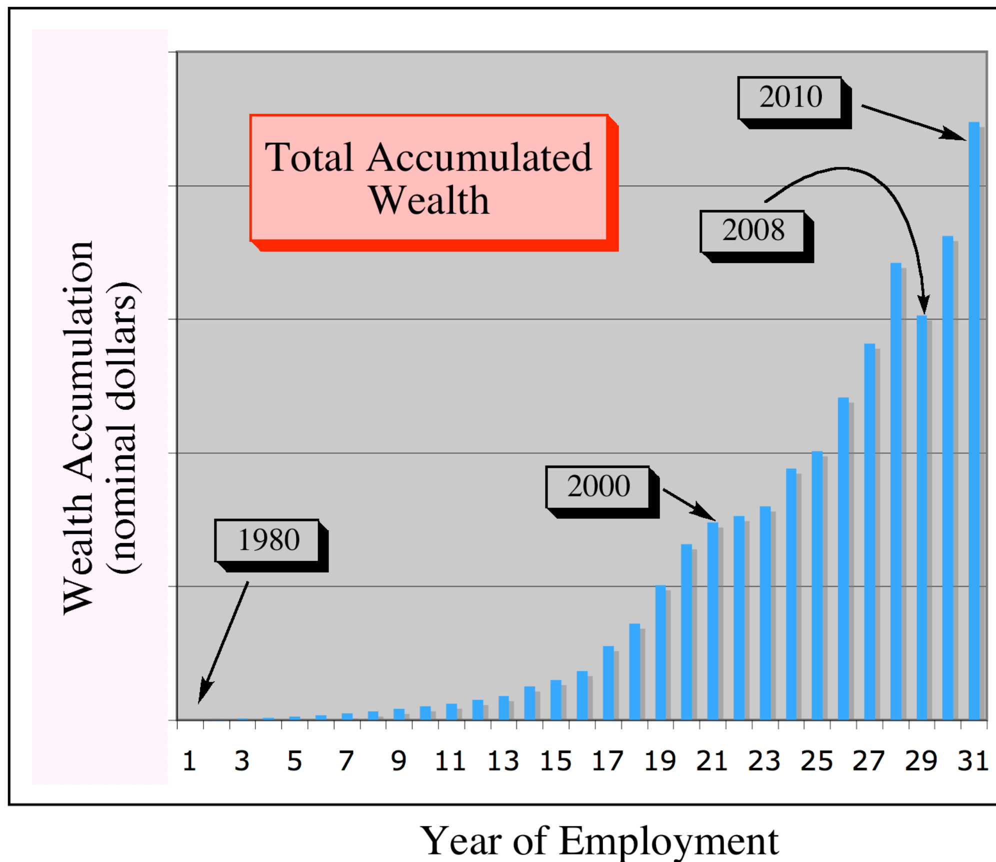


Figure 3. Wealth accumulated versus year of employment (excluding physical precious metals and housing). Absolute numbers of dollars have been omitted.

Of course, nominal dollars are a fiction. I monitor progress by what I call a salary multiple, which is defined as the total accumulated investable wealth (excluding my house and physical precious metals) divided by annual salary (line 22 of on the 1099 form ex capital gains). Over the 31-year period my salary rose twelve-fold, which I can fairly accurately dissect into a fourfold gain resulting from inflation and a threefold gain (relative to starting salaries of newly minted assistant professors) resulting from increasing sources of income and merit-based pay raises. My accumulated wealth normalized to the moving benchmark of a

rising income is plotted versus time in Figure 4. The fluctuations visible in Figure 4 but not in Figure 3 result from income variations. My target is to double the number to 20 multiples over the next 15 years. A quick calculation shows that my 11-year accumulation rate beginning 01/01/00, a period in which the S&P returned almost nothing, is annualized at 12%. My one-, five-, ten-, and fifteen-year rate of wealth accrual also beats Buffett's (using Berkshire as a proxy). If you go back any further the comparison rapidly turns unfavorable.

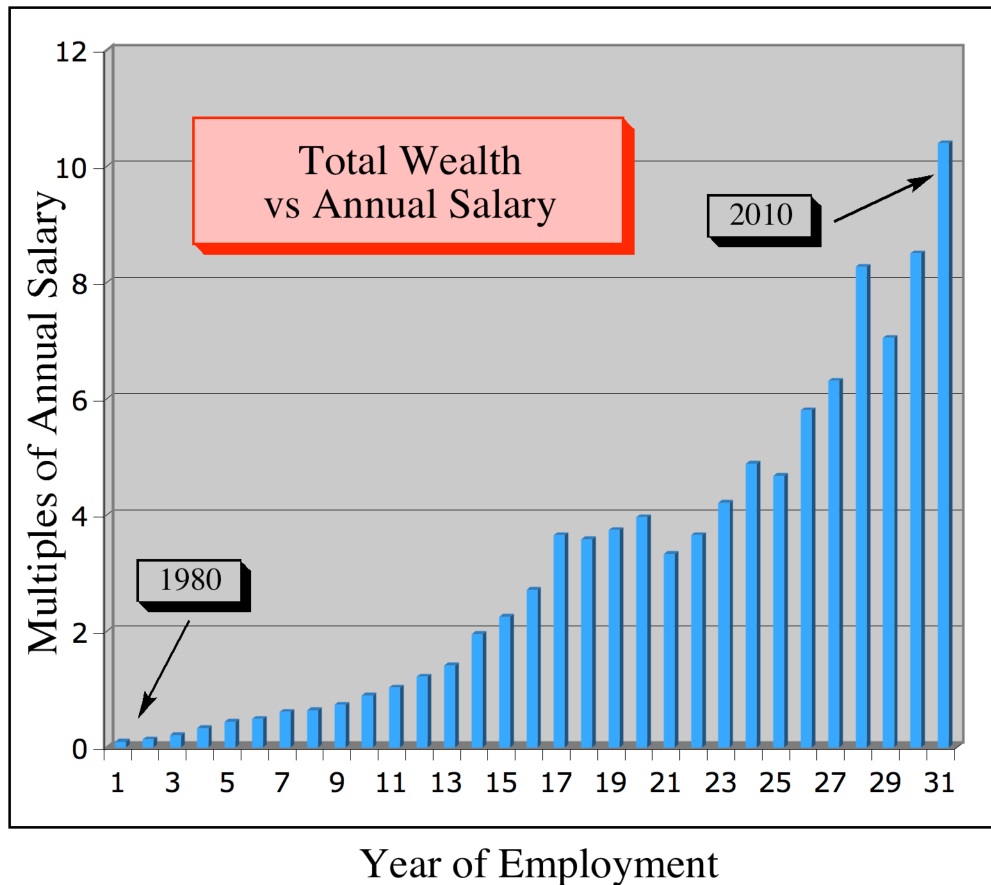


Figure 4. Total wealth accumulated measured as a multiple of annual salary versus year of investing.

**Just Thoughts**

I've written a half dozen blogs over the years on websites hosted by an eclectic mix of characters including Jim Puplava, Elizabeth Warren (pre-fame

days), and Lew Rockwell. I have also been a guest on a couple of local and regional radio broadcasts (which I found challenging and exhilarating.) Oddly enough, my first urge to go off script was published in Encyclopedia Britannica's annual review (Organic Chemistry section) in which, out of boredom with the task, I noted that patents emanating from academic labs were disruptive to pharmaceutical companies. This proved to be the first treatise on the subject [2]. In more recent and conventional blogs I have expressed my disdain for Greenspan [3], challenged Buffett's sincerity [4], compared chemistry and monetary policy [5], and described minimum wage in units of large pizzas [6]. I had three lines of fame in a Wall Street Journal article on the flash crash [7] by David Weidner:

> "Wall Street is a crime syndicate, and I am not speaking metaphorically...The banking system is oligarchic and the political system has metastasized into state capitalism. The most important market in the world-the market in which lenders and borrowers meet to haggle over the cost of capital-is the most manipulated market in the world."

Weidner described me as "in the extreme." He didn't even print the good stuff. For the most part, however, I don't write blogs, only read them. I do chat semi-anonymously, which helps me formulate my ideas. Curiously, the looseness of blog prose is starting to creep into my scientific papers [8].

I must confess that I am a total sucker for what Taleb and Kanneman would call the narrative bias: I love a good story that fits together well. I also am a bit of a conspiracy theorist, tending to see deeds as sinister. In defense, anyone who thinks that people of wealth and power do not conspire is even crazier. With that said, let us continue.

**Inflation Versus Deflation.** I love metaphors and similes. A particularly instructive one is Parker Brothers, *Monopoly.* The players all start out with reasonable amounts of money. As the game proceeds, players collect $200 by simply passing *Go* and use this money to speculate on real estate. By the end of the game, only $500 dollar bills are worth anything, the whole thing blows up, and

most of the players end up destitute. I wonder why the originator of the game (Elizabeth Magie, not Charles Darrow) didn't name it *Inflation*. In a twist of irony, an original game board sells for about $50,000.

I went to a lecture by Bill Dudley with a very bright former Citigroup guy and his son who manage money privately. We chatted for two hours afterwards and agreed on everything: Dudley was slapping the baloney on thick, and we are headed for years of pain in so many agreed-upon ways. There was only one minor disagreement: They are 100% long-duration treasuries, and I am deeply hedged against inflation. How very odd. This is the essence of the raging inflation-deflation debate. So here is the inflationist's view.

Every once in awhile a graphic really speaks to me. This year's winner goes to Casey Research and their graphic entitled, *The Real Cost of Living* (Figure 5) showing the year-over-year change in commodity prices along with the government-reported CPI (tucked in the lower right). I sent this to a famous economist who I had a minor disagreement with over the merits of the CPI, and he responded, "What is going down?" I would argue that the veracity of the CPI is going down. Even former Secretary of the Treasury George Schultz in an *Econtalk* interview summarily dismissed the veracity of government statistics. How can economists possibly put together viable models that use the CPI to correct for inflation?

For the sake of this discussion, let us assume in the abstract that the CPI and other statistics coming from government sources are actually correct. The fair and balanced financial media rationalizes this tame inflation by noting that there are no wage pressures. This is new era thinking at its finest: The bad news is that the cost of everything is going up; the good news is that our salaries (if we still have them) are not keeping up. One can take the equally unpalatable approach by accepting inflation as a given and simply dismiss rising prices as a zero-sum game. Former Fed governor Alan Blinder, for example, asserted that the falling dollar (inexplicably viewed by some as different than inflation) only matters if you travel abroad. With all due respect (not really), please tell me he's lying because he cannot be that ignorant. Inflation moves unevenly throughout the economy, and we've got the worst kind of imbalances brewing.

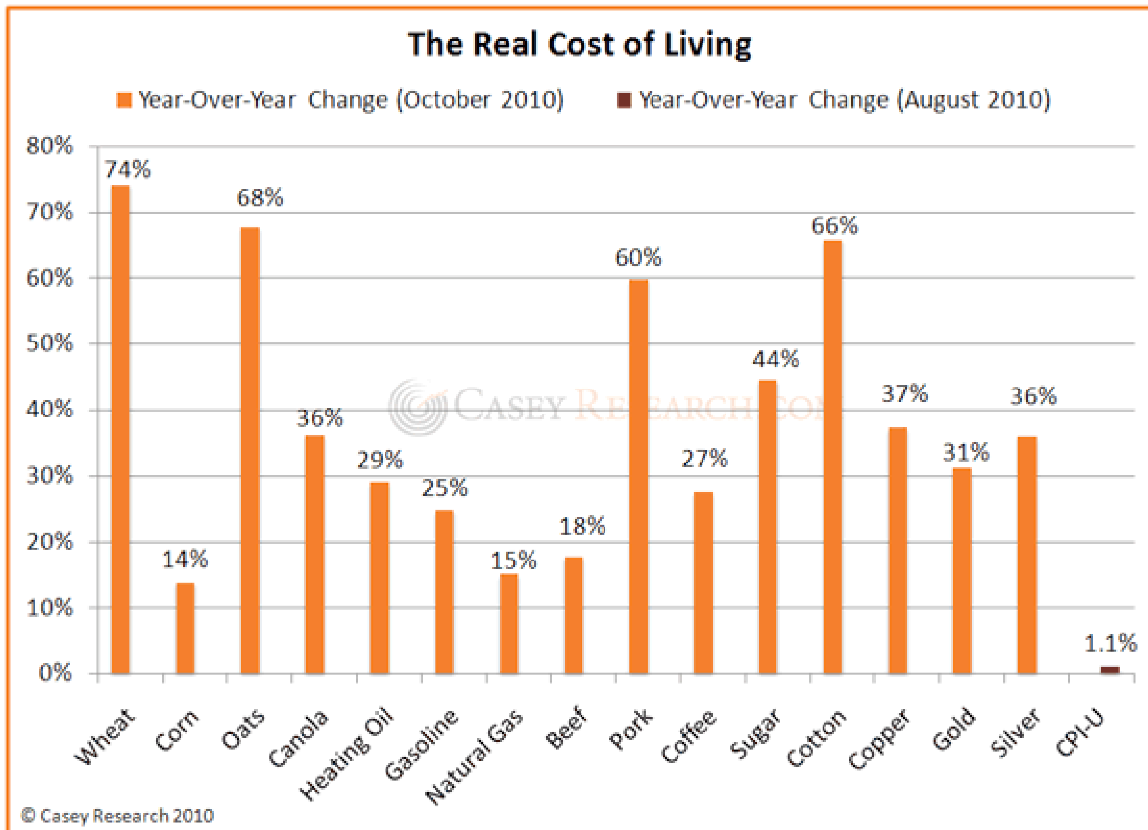


Figure 5.

How about the influence of inflation on your IRA? Recall those advertisements that promised you millionaire status if only you would sock away $2000 per year every year until age 65. Do you remember the disclaimers that the returns are not inflation adjusted? Me neither. What do you think a car will cost in 2050? If inflation follows historical paths, compact models might start at about $130,000. Let's drill down to find more hidden costs of inflation. The inflation-adjusted DOW rose 1.7% per year over the highly prosperous 20th century. Come again? Yes, you read that right: 1.7% ex dividends as illustrated in Figure 6. Moreover, the inflation adjustment in Figure 6 uses the highly suspect CPI, which arguably is understated by, oh, about 1.7% per year. (A case for 5% annualized inflation over the decades is defensible.) In essence, your capital gains are an inflationary illusion; you make your real gains via dividends. (Ouch.) If you invested $1 million in an S&P index fund in 1970 you would have enjoyed a four-

teen-fold capital appreciation (ex dividends) or what Peter Lynch would call a 14 bagger. Unfortunately, up to 7 of those bags are inflation, leaving you a 100% real capital gain over 40 years. (Is that a one bagger or two?) After 20% capital gains tax, your 100% capital gains are now only 80%. If you are inside an IRA, it comes out at an even higher tax rate. To stretch the Peter Lynch metaphor, I think you just got caught holding the bag. Here's a little maxim that is worth pondering: *You save for retirement and invest to counter inflation.* It's not quite right, but it's uncomfortably close.

Figure 6. Inflation-adjusted DOW showing 1.7% annualized capital gains

It's now official: the Fed is trying to trigger inflation. [Sarcasm off.] According to Rogoff and Reinhart (and others), inflation can only cure our ills if it is unanticipated. Once the market senses the coin clipping and starts correcting for it, out comes the piece of string to push on. The good news is that the ruse seems

to be working; none of the pros see inflation in the near term. The bad news is that they might be certifiably nuts. Condos in Vegas might be getting cheaper, but the prices of things that *I* care about are showing inflationary pressures *now*. If, for example, you can get past that $150 per barrel oil blip, you may notice that oil is up tenfold in a dozen years. Thankfully energy is sufficiently unimportant that they exclude it from the core CPI. Also, try going with your maid, nanny, or butler to the grocery store; prices are soaring. Fortunately, food gets excluded from the CPI too. College tuitions are said to have risen threefold above inflation over the last few decades. I beg to differ. To the extent that tuition measures the cost of running a small city, I think college tuitions may be the single best measure of inflation. I submit that the CPI has failed to track inflation. (I must admit that some of that increase comes from squandering student loan dollars that flow in torrents.) Even those 99.99% pure gold-clad coins on TV have reduced their content from 53 mgs to 14 mgs. How Roman. I'm not buying those anymore.

Resist that temptation to dismiss me using some mumbo jumbo about other definitions of inflation. I know most of them (including that based on the recently assassinated M3 money supply). My favorite, however, is that of Roger Bootle coming care of Peter Warburton: *inflation occurs when different classes start competing for their share of the pie*. It would be hard to argue that class warfare is waning. If you have lingering doubts, check out videos by Walstreetpro2 posting on Youtube from an undisclosed trailer park [9]. I've listened to his rants, and what is even more shocking than his anger is his grasp of what is happening.

What about money velocity? Maybe the Fed is pumping out money, but it is simply being hoarded by the banks causing velocity to plummet. My metaphor is that we are creating a gigantic monetary capacitor: they keep charging it but there is no current until one day—crack!—it discharges. Of course, when that day comes the crooks will claim nobody saw it coming whereas the clueless will profess to have seen the risks all along. There will be a lot of fibbing in both camps. When it is time to mop up all this liquidity, what are the Feds going to sell into the open market, CCC-rated MBS's? Nope. They are going to raise interest rates paid by the Fed so that banks can take all that money they borrow from the Fed and lend it back to the Fed for an even bigger spread. I hate carry trades, but this Fed-to-Fed carry trade is one for the ages.

Let's come at this tame inflation model from another angle. Michael Boskin and his commission invented new metrics for inflation to reflect the changing quality of goods; intermittent windshield wipers are an oft-cited example. I have been assured by one of his colleagues that he is a good guy and brilliant economist with pure intentions. Nonetheless, I think he screwed the pooch. His methodology with its hedonic adjustments, product substitutions, and very odd statistical weightings opened the door for politically motivated distortions of a higher order. I also think they may even have some of it backwards. By way of example, we own a 70-year-old refrigerator in a cabin that still works. Our modern refrigerators, by contrast, last about 10 years. Some of the food inside the fridge outlasts the fridge. Doesn't this call for a sevenfold inflation correction for accelerated depreciation? Another example: Is your new I-phone cheap because it is so cool and convenient or is it expensive because you will buy 20 to 30 of them over the lifetime of a single rotary phone? You get the point. The Greatest Generation amassed wealth in the form of labor-saving material goods. Their first appliances must have seemed straight from God, required occasional repairs, and lasted for years. By contrast, the boomers are loaded with material goods that demand constant replacement. The good news is most of your labor-saving devices are brand new. The bad news is that most will be brand new this time next year also. The net domestic product (NDP)—the gross domestic product corrected for depreciation—would be shocking if anybody started calculating it again.

**Interest Rates.** I cannot imagine the shock of bond traders when QE II finally arrived and interest rates darted higher. Was that the bottom of the secular bond bull market? Nobody knows, but I say with great conviction that the secular bond bull (Figure 7) is long in the tooth and will eventually succumb to the bond vigilantes. Who are these bond vigilantes and where the hell have they been hiding? The other day Roubini was asked this and fumbled it. The simple answer is that bond vigilantes are the marginal sellers who will slowly, inexorably drive prices lower and rates higher. I am guessing the posse will be comprised of sovereign states. When those rates rise in earnest owing to suffocating debts and reckless central bankers, we will be doing some serious muddling. Not

convinced? Buffett wrote a brilliant article in *Fortune* in 1999 [10] describing how secular bear markets in bonds are the root cause of secular bear markets in equities. Period/full stop. If so, what happens when a secular bear market in bonds begins after ten years of an equity bear market? Oddly enough, Buffett completely contradicted himself in 2008 while cheerleading for some bailout money. I get all warm and fuzzy knowing that I helped bail out the Oracle of Omaha and all the Buffettologists [4].

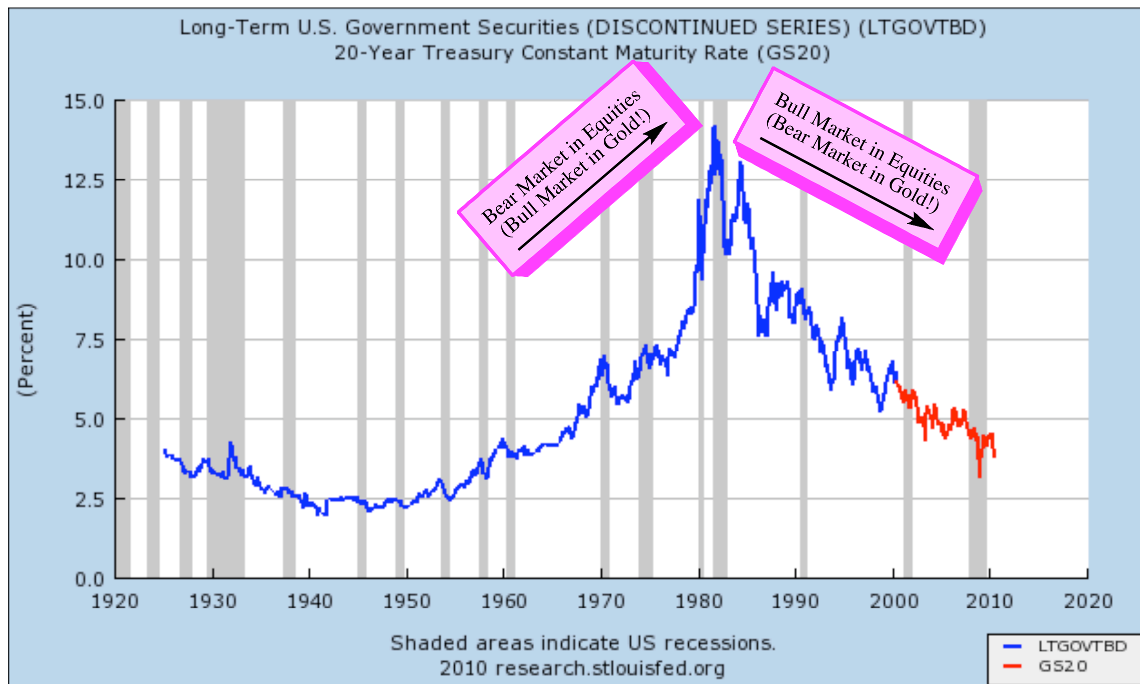


Figure 7.

**Debt Without Borders.** Another news flash: Debt has crept into all aspects of the global economy, reaching extraordinary levels based on historical norms. In an email exchange with one of Morgan Stanley's finest in October 2009, I expressed concerns about Spain. He responded, "I'm still not sure why they haven't already blown up." I spoke a lot about Club Med implosions in last year's review and won't repeat my concerns. Here's what I believe: The whole world can be in debt, inflating currencies, and heading for global carnage, which means that blindly benchmarking a currency to other currencies is lunacy.

More locally, credit card debt has now been surpassed by student loan debt. This was really easy to achieve because the 18-22 year olds are not known for their deep-seated understanding of debt. They don't even have fully formed frontal cortexes, the brain's filter against bad ideas. It is difficult to imagine how all the English, sociology, and philosophy majors will pay off their loans and accrued penalties. Even technical training may offer limited protection as Thomas Friedman's Earth keeps flattening. It seems likely that student loan forgiveness will arrive under the auspices of some program named to suggest that we are making America great. On the other end of the spectrum, the boomers have worked a lifetime and still have nothing to show for it. Although flat broke, they defiantly announce that they will work until they drop. I got news for you guys: your employers may have a more jaded view of doddering employees with oxygen tanks in tow. Corporations supposedly have bundles of cash waiting to be unleashed on capitalism; I am speaking a little out of school here, but I suspect that those who say this are not looking at both sides of the balance sheets. Surely some of this cash is on loan from God (via Lloyd Blankfein *et al.*).

Municipalities are also up to the second stories of Town Halls in problems so diffusely distributed that engineered bailouts will be tricky. Prichard, Alabama placed itself at the vanguard by defaulting on its obligations to retired municipal employees. There must be a lot of mayors scratching their chins and saying "Hmmmm...I hadn't thought of *that*." I think we might witness a consolidation phase exemplified by Pennsylvania's rescue of Harrisburg. If the states bail out the thousands of municipalities, then the Feds can bail out the states. It would be a bailout tree. The Feds can start with Illinois. The Illinois teachers pension fund is rumored to be 40% funded. Simply stated, there is no way they can fill this gap through income and investment. The Feds better hurry before the governor of Illinois starts looking to Prichard for some fresh ideas.

It all keeps pointing back to the Federal government as the sugardaddy. Uncle Sam has a huge and growing debt (even when normalized to GDP). Thanks to American exceptionalism, however, we will continue to accrue debt through huge deficits in perpetuity, right? I am reminded of my favorite quote from *Silas Marner* (the *only* lines that I ever read from it):

> "The lapse of time during which a given event has not happened is, in this logic of habit, constantly alleged as a reason why the event should never happen, even when the lapse of time is precisely the added condition which makes the event imminent."

This is really a variant of Stein's Law, attributed to economist Herbert Stein, that is a little closer to my style: "What cannot go on forever, stops." I think the Law of Unintended Consequences, another maxim for the ages, will eventually corner us at the national level. The triggering event is unknowable, but my money is on a requisite defense of the dollar (raging, undeniable inflation) or rapidly rising rates on long-term treasuries. (I cannot rule out the election of Sarah Palin and running mate Paris Hilton.) If Rogoff and Reinhart are correct, we will default on our obligations abroad using deflation—the eat and dash model—and default on domestic obligations through inflation.

**Gold.** Just look at that curve in Figure 8! It makes me tear up with joy knowing that I rode it the whole goddamned way. There is a critical question going forward: Are precious metals in a bull market or a bubble?

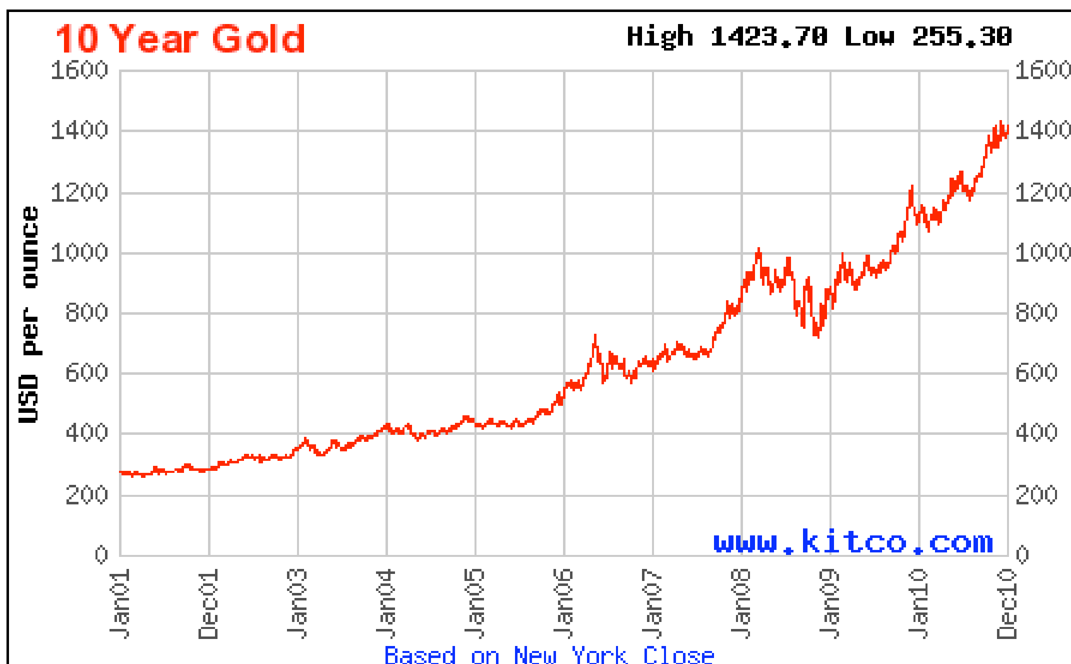


Figure 8.

To capture the essence of the bull-bubble debate, we could try some definitions:

> *Bull Market*-An asset class that has experienced considerable appreciation in which you currently have a significant investment.
>
> *Bubble*-An asset class that has experienced considerable appreciation in which you currently have no investment.

That didn't really help, although it does explain the intensity of the discussion on the blogs. So is gold over-owned? I simply don't see it. I was the only buyer of bullion from my local coin dealer for years. Now he has several buyers but still a ton of sellers. My smart, relatively affluent colleagues are not buyers yet. Kiosks offering to buy gold jewelry are by no means a sign of a top; these are new-era pawnshops. When I see retail buyers in number, I will start looking for the exits. The bubble callers on TV are legion, and, of course, these are the guys who never owned any gold. Admittedly, there are big-money guys betting on gold; David Einhorn got "the gold talk" from his grandfather but finally grasped its meaning in 2005. It has been suggested, however, that gold investments constitute about 1% of the investable assets of society. (I have no way to confirm this.) If that is true and we return to the historical value of, say, 5%, that would constitute a fivefold gain relative to other asset classes.

It is difficult to get credible numbers on precious metal hoards for perspective, but let us try nonetheless. The US gold stash is said to contain about 8,000 tons of gold (assuming they still have it) currently valued at $350 billion. It sounds like a lot of money until you realize that it is on a par with the market cap of Apple Computer and only 60% of QE II. It is instructive to look at the omnipresent DOW-Gold chart in which the price of the DOW is measured in ounces of gold (Figure 9). The great opportunities in 1929, 1967, and 2000 are obvious, and they correlate with historically interesting turning points in the equity markets, but isn't this game nearly over? Not necessarily. If you squint at the residual drop remaining and do a little arithmetic, you discover that a DOW-Gold ratio of 8 leaves a residual 8-fold gain before it reaches what visually looks like a rock-

hard bottom at unity. It explains how some project $10,000 gold (assuming our DOW 10,000 hats have not gone out of fashion). Jim Rickards got a few gold bugs' hearts pounding by noting that a 100% gold-backed dollar predicts $53,000 per ounce gold. Jim is knowingly reaching on this, and surely the path to a fully gold-backed currency would likely require some megamuddling. Until then, reckless central bankers—*Governors Gone Wild!*—who think their job is to trigger inflation are doing their best to keep the bull (or bubble) at center stage. Sovereign states have become net buyers, and they are not exactly high frequency traders. Some say that the moment the Fed taps the brakes (in the Year of Our Lord 2050?), gold investors will hit the windshield. These schadenfreudians should check out the 70s for a counter example; gold and treasury rates tracked higher for years and peaked together within months. Maybe this time it's different, but maybe not. With all that inflation lurking in the shadows the Russians, Chinese, and I are likely to white knuckle those metals through more dips.

Figure 9.

**Silver.** The ten-year bull market (bubble) in silver is illustrated in Figure 10. There is clearly *something* going on. Maybe silver is playing catch-up to gold; it's certainly turning the silver shorts into catsup. Recent articles by Eric Sprott posted at Zero Hedge may be useful in understanding the silver market [11]; I suspect he gets his data from GFMS [12]. Silver offers a compelling narrative that would make Taleb and Kanneman grimace. The above ground silver supplies were reputed to be in the ballpark of 14 billion ounces in 1900. Once silver got pricey, silver coinage was abandoned (circa 1964). Dishoarding of huge sovereign silver stashes suppressed the price of silver and decimated the mining industry for years. The Hunt brothers smelled opportunity in the late 70s, but their failure to corner the silver market was a poignant lesson in poor timing. The resulting $50 per ounce price, however, shook the loose silver from under seat cushions and out of jars on bureaus, setting the stage for the next attempt. After a savage 20-year bear market in silver in which independent silver miners went nearly extinct, the total silver supplies are estimated at 700 million ounces. GFMS estimates that the above-ground supplies of *accessible* silver bullion have dwindled to 66 million ounces: This is $2 billion at current market prices, the market cap of MBIA, the Karen Ann Quinlan of bond insurers. The US hoard is supposedly down to 7 million ounces. (When I compare my stash to the Fed's, I go slack jawed.) This is $200 million at current prices, the market cap of Beazer Homes. For those who are wondering, photography is *not* part of the plotline and hasn't been for years owing to 99% recovery rates. Silver is, however, indispensable to (and unrecoverable from) virtually every electronic device. If the numbers cited above are near reality, we are one crazy hedge fund manager away from an unimaginable example of price discovery. Maybe Max Keiser's attack on the silver shorts isn't completely nuts.

Figure 10.

**Housing and Foreclosures.** The new-era bankers' credo: *We commit no crime before its time.* Could the mess get any bigger? It all started when the bankers *et al.* and political hacks teamed up to inflate a gigantic housing bubble on the assumption that people who cannot afford a house should own one anyway (and because there was money to be made). Who could forget the must-see commercial about the house that Suzanne researched (The Wife from Hell) [13]. Along comes the proverbial pin in the form of FASB 157 forcing mark-to-market accounting, Bear Stearns blows up, the dominoes begin to fall, and the bankers declare that nobody saw the crisis coming (and you cannot throw somebody in jail for being a complete idiot). I could probably name 500 people who did, many well before 2007. I gotta figure the bankers are big fat liars, because they couldn't be *that* clueless. During the crisis, the bankers whipped up a frenzy and duped Bernanke and Congress to take profoundly ill-conceived action by bailing out the crooks at top dollar. As the dust settled, mortgage fraud could be found in every

nook and cranny. We also discovered that the electronic property registration scheme (MERS) designed to expedite the raping and pillaging is a legal train wreck. Properties with hundreds of years of an unbroken ownership lineage are being thrown into a legal void by the simple act of foreclosure. Reports of homeowners successfully challenging foreclosures in court started surfacing, triggering moratoria on foreclosures to buy the bankers enough time to figure out their next scheme. The game then did a complete reversal: the banks started installing retired judges to run high-throughput foreclosure mills characterized by reckless disregard for stringent foreclosure laws. Previously missing documents (missing because they would have served as evidence in fraud cases) are rediscovered in filing cabinets, only to be shown to be complete fabrications (robosigned).

Why did foreclosure moratoria give way to accelerated foreclosures? This is where the plotline is awfully murky. I believe that the CDOs (securities backed by mortgages) and the synthetic CDOs (unbacked derivatives designed to mimic the CDOs but replicated en masse) became legally tangled during the bubble. The banks *et al.* must have realized that not only is the right of foreclosure open to debate (which stalled the process), but the actual ownership may be redundant (causing a mad dash to grab the houses before another bank does). Think of an estate settlement in which six wives show up to collect on one guy's estate, and none has a marriage certificate. Rumors began to surface that the local authorities—authorities who themselves may have been cored out by the bankers—refuse to foreclose on homeowners. It may not be just sympathy; local heads of municipalities realized that foreclosed homes represent lost tax revenues. Thus, the local authorities are deciding they have no beef with delinquent mortgage holders *provided they pay their taxes* (which is followed by a couple of winks to the homeowners). It's hard even for the global banking cartel to foreclose on a house without local help. The saga continues.

The root cause of the mess is not gone. The most replicated financial chart on the internet is that showing mortgage resets (Figure 11). I had dinner with the former CEO of a Wall Street banking subsidiary; I brought a number of graphics including that plot whereas he brought only that plot. As easily seen, we have another year of serious resets coming straight at us. These aren't subprimes in which we will be evicting undocumented aliens, but rather mortgages held by

soccer moms and hockey dads. These folks, the centerpiece of American exceptionalism, may refuse to pay *and* refuse to leave. This would be both a business decision (which is valid) and an emotional response to being totally pissed off (which probably feels *really* valid). This is capitalism with a populist flare. It is also clear that those extralegal foreclosures in which Federal laws were completely abandoned for the sake of expediency may come back and haunt the banks. I suspect that fabricating documents is still against the law, even for bankers. To keep track of this continuing saga, I watch the brightest guy in the room, Chris Whalen of Institutional Risk Analytics. (Despite having read too many books with the words "crisis" or "meltdown" in the title, Whalen's new book waits on my nightstand.)

We should eventually burn through this inventory, right? Maybe. These gigantic McMansions made out of cheesy materials holding an estimated 3.8 occupants represent a truly dazzling malinvestment. It is not obvious to me that anybody will want or can afford this much house. Isn't there some deep discount that will move this inventory? I'm not so sure. Imagine the next generation—your kids—having the financial resources to heat and maintain such monstrosities as they start to rot. Hard to picture, eh? Will these student-debt-laden upstarts be able to pay for a new roof or a paint job on a 5,000 square foot house? Will they be dumb enough to assume the tax burden on a piece of property with the highest assessment in town? Rising taxes necessary to bailout the states and municipalities present serious risk to those with a job or assets.

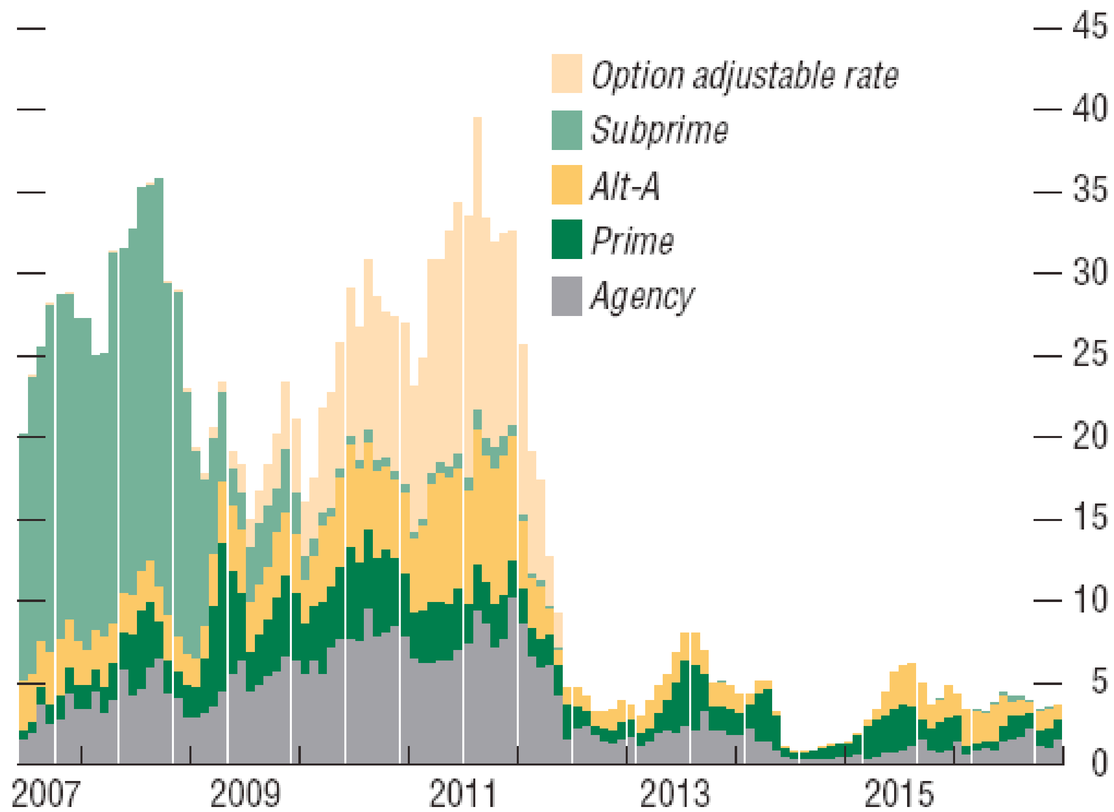


Figure 11.

**The Resilient Consumer.** As the endearing consumer analyst Howard Davidowitz would say, "They're tanking!" The public is now keenly aware that they cannot keep spending no matter how much the media pushes them to buy one for the gipper. The Paradox of Thrift is a maxim that suggests the economy's need for consumption may be in conflict with individuals' needs to be thrifty. This is not paradoxical; it's wrong. As a nation, we need to make stuff and sell it abroad. Individuals need to improve their balance sheets by spending less and earning more. Period/full stop. It may be too late for many of the boomers who are broke, live in houses with big mortgages and no equity, have paltry retirement accounts, and are 20% unemployed or underemployed. Nonetheless, they must try.

I imagine that we will begin reading stories of boomers getting stuck in get-rich schemes. I can picture them taking the tail end of their nest eggs and jumping on hot asset classes or starting some high-risk business (maybe buying a franchise) to make up for lost time. It's fourth and fifteen deep in their own territory with seconds on the clock: What are the odds that they complete that Hail Mary pass? At the other extreme, we have the youngest workers—*Generation Y*—with lousy job prospects, non-extinguishable student loans owing, in part, to the weakened financial position of their boomer parents, and arguably reduced motivation stemming from years of digital lobotomies. The good news is that a couple more years of muddling and they will no longer need a reality check. They are having their come-to-Zeus moment early in their lives. There is statistical evidence, however, that poor job opportunities and economic hardship in early adulthood inflicts long term career damage, but it could be part of the healing process as described in Straus and Howe's *The Fourth Muddling*. (Just kidding: It's *The Fourth Turning.*)

**Energy and Resources.** If you haven't watched Chris Martenson's *Crash Course* [14] you owe it to yourself. It's a brilliantly simple 3-hour treatise on resource depletion. As a side note, I find that economists seem to have a terrible blind spot for depleting resources: Demand may generate technology and new resources, but it will not always squeeze more out of a truly depleting resource.

I am wildly bullish on energy as an inflation hedge and increasingly prized asset. I own a lot of energy and resource funds (15%; vide supra). They look good if inflation rages on. They look even better if the global economy recovers, and the new normal is just like the old normal. I am particularly excited about natural gas-based equities. The logic is simple: there are gobs of natural gas, it is dirt cheap, and the equities act like dead money. I guess that needs a little explanation. You could learn a lot watching my dog catch squirrels. She quickly learned that you don't run at the squirrel; you run straight to the tree. The Wall Street guys won't invest unless they can make money *today*. They chase squirrels. As oil gets harder to get, eventually natural gas will start looking very attractive. To beat Wall Street, all you have to do is run to the tree. Natural-gas-

based investments are cheap right now, but they may be an un-fracking-believable opportunity in the future.

Just-in-time delivery, erratic weather, and providing food to the World are not always compatible, causing consternation in the halls of power. The big intellects inhabiting the Council on Foreign Relations worry about it a lot. Water is also said to be a problem. This is certainly *not* true in Ithaca (provided you have a good sump pump). Other areas are in more trouble. Maybe Florida can desalinate the Gulf of Mexico with cool tech someday, but Phoenix, Vegas, and other cities relying on fossil water in depleting aquifers seem destined to become Western ghost towns. Lake Mead, the largest reservoir in the US, is turning into a puddle. I haven't a clue how to invest in "water", despite considerable effort over a number of years. I repeat: Watch *Crash Course* [14].

**Politics and the Federal Reserve.** If you have not read Bill Fleckenstein's and Fred Sheehan's *Greenspan's Bubbles* you should. It is a timeless record of Greenspan's disastrous reign as emperor of the FOMC. He is arrogant, self-absorbed, and incompetent. Don't agree? Read the book and then let's chat. By contrast, I put Bernanke in an altogether different camp. He inherited a mess and tried to do his best to stem a potentially catastrophic financial collapse. Unfortunately, I think he was working from the wrong paradigm. (Did that cocky chemist just say that?) I also think Bernanke got duped by Wall Street in a panic to bail out the criminally insane (OK, criminally negligent). He failed to support taking possession of failed institutions. He failed to take Bagehot's advice to lend at punitive rates. Now he is heading down a very dangerous path. Explicitly pumping the stock market is inexcusable, affording only a temporary salve with disastrous consequences. Using rhetoric to talk down interest rates prior to QE II was a desperate strategy that is already failing as evidenced by spiking rates. Leveraged speculators bought the rumor and now are selling the news. His interview on CBS's *60 Minutes* was wretched. He looked haggard and unsure of himself. I think he is uncomfortable lying. I sat up when he declared "100%" confidence that he could stem inflation. His assertion that "we can raise interest rates in 15 minutes" is not the same as controlling inflation. I betcha Paul Volcker blew a snot bubble. Bernanke is cornered.

When I think about the 21,000 loans and gifts made covertly to private and public organizations *way* outside the Fed's jurisdiction during the crisis, I can taste vomit in my mouth. Mention of QE III will elicit a projectile vomit. Where did this multifaceted mandate to fix everything come from? Was it self-proclaimed (imputed) or did Congress pass some new law? (Send me an email if you know.) James Grant refers to it as the ultimate "mission creep". I suspect that the Federal Reserve governors all suffer from Hayek's "fatal conceit"—the misguided belief that one can engineer something that can only be generated by evolution. It is often said that this same gaggle of governors' aversion to inflation is in their DNA. This is a bad joke. Their aversion to corrective processes (natural selection) in the financial markets and economy is all I see. I may be wrong about their motives, however. Maybe the Fed is not simply captured by the banks, but rather explicitly works for the banks and could give a damn about the occasional 80-car pile-up that occurs when everybody is running at full throttle. Distrust of the Fed will continue to grow, possibly leading to some curtailing of their power.

**Rise of Austrian Economics.** To end on some cheerful notes, I should first say that Austrian economics is clearly in the throes of a renaissance. A dozen years ago you couldn't find anybody who knew what the hell you were talking about if you mentioned the Austrians. The Austrian-Keynesian debate is now on, and I am optimistic the Austrians will at least inflict some damage. Admittedly, the free marketers got a black eye as the population equated Wall Street's recklessness with free-market capitalism, failing to notice that the easy money of loose monetary policy was the most insidious of government interventions. (Apparently, moral hazard is like procrastination: We can worry about it later.) The uphill battle for the Austrians is to convince the world that Greenspan is not their spokesperson, free market economics is not lawless anarchy, and a legitimate role of government is to ensure a level playing field. I correctly predicted last year that Ron Paul would fail to audit the Fed. I am heartened, however, by the coming years in which he gets to ride roughshod over Bernanke as Chair of the Monetary Policy Subcommittee. It should be quite a spectacle.

**Are we there yet?** In a word, no. Andrew Mellon was right; we will have to purge the rot. John Bogle believes that some form of retribution is a necessary part of the process. Unfortunately, Pecora Commission 2.0 was a dud. I just read that Steve Rattner, money manager and auto czar extraordinaire, got caught in some massive kickback schemes in conjunction with state pension plans, and Andrew Cuomo let him off with a fine. Put them both in jail, and throw away the key. I hasten to add, however, that rounding up a bunch of hedge fund managers for a perp walk is *not* the solution. (In a sense, their job is to game the system.) The system itself is rotten. With that said, however, we are making progress. I take heart from the assertions of Simon Johnson that change will not be an event but rather a highly incremental process filled with fits and starts. Resistance to change (especially from the banks) is to be expected, but eventually we will have to sweat out the fever. Until then, we have to grow assets by saving aggressively and invest by running at the tree rather than the squirrel. We also must defend against local, state, and Federal agencies looking to reinforce their sagging balance sheets with any money they can find. I have strategies that are better left unsaid. There will come a day, however, when equities are fairly valued, corporate accountants generate valid earnings numbers, houses are bought with 20% down and affordable monthly payments, economics departments have Austrian economists in numbers, interest rates reflect the true opportunity costs that a borrower must pay to a lender for the capital, a more humble Federal Reserve doesn't try to impute economic outcomes, the populace is no longer deeply hateful of Wall Street and bankers, and Julian Assange is no longer a folk hero. Don't start holding your breath just yet.

**Audiophilia.** Now for a light finish for the two of you who made it this far. I have become an audiophile—an enthusiastic consumer of podcasts and audiobooks. The podcasts work especially well when I am doing mindless work in my office. There are, of course, countless sources, but let me give a plug to two. Eric King's *Kingworldnews* is excellent [15]. He has good guests, asks excellent questions, and patiently waits for the answer to evolve. The second is Russ Roberts' *Econtalk* [16]. Russ is an Austrian economist without the rough edges, and he is the most thoughtful interviewer I know—Charlie Rose but with a pro-

found understanding of economics and a very sharp wit. There are over 200 hour-long podcasts in the *Econtalk* archive. The titles look strange at times, but the quality is uniformly high.

I discovered audiobooks by screwing up an Amazon order. I keep them in my car at all times. They beat talk radio and allow me to markedly expand the number of books that I "read". (You purists who think this is not reading need to get with the program; it is about learning through any medium.) Audiobooks are not just for long trips but for all commutes. My wife cannot understand why I cheerfully run errands when, in reality, its akin to being asked to read for ten minutes. I have replaced short (and capricious) flights with longer drives. (I sure miss those TSA guys.) Probably 90% of big releases now come out in audio. A great source of scholarly audiobooks that could be easily overlooked are marketed by The Teaching Company. You get about 20 hours of masterful college-level subject matter for under $100. They cover topics from history of science, the Middle Ages, ancient Rome, history of music, linguistics, neurophysiology, and even finance and economics. (NB-Never pay retail; they are always going on sale at 80% discount.) Try to get your kids listening; it's a natural for them. I failed until my youngest drove across the country; he kept calling me to discuss the book.

**Acknowledgements**

I have had the tremendous pleasure, honor, and benefit of exchanging ideas with money and hedge fund managers, academic and Wall Street economists, journalists, authors, bloggers, geologists, peak oil theorists, Federal regulators and TARP overseers, central bankers, and historians, some of whom are mentioned above. Last but not least, I thank collectively brilliant groups of whack jobs on the Wall Street Examiner and Wall Street Bear chatboards. Some I have known for a decade. I offer thanks for the instructive chats over the years.

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