

2013 Year in Review: Austerity is not a policy.

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Background

“Dear Cornell students, don’t learn economics from your chemistry professor.”

~Matt Yglesias, *Salon*

Every December, I write a Year in Review or, as my wife calls it, my Urine Review.^{1,2,3,4} It has found a home at Chris Martenson’s website PeakProsperity.com⁵ with a secondary posting at ZeroHedge,⁶ whose rabid followers crashed the server last year by clicking the crap out of it. What started years ago as a simple summary intended for a couple dozen wingnuts morphed over time into a much more detailed account that accrued upward of 100,000 clicks last year.

Owing to a complete lack of street cred, I’ve got to throw my elevator resume at you right here, right now. I’ve been quoted in the *Wall Street Journal* on the Flash Crash (no knowledge needed)⁷ and been interviewed by Lauren Lyster on *Capital Accounts* (Russia Today),⁸ Chris Martenson (Peak Prosperity),^{9,10} and James Howard Kunstler (Kunstlercast).¹¹ I found my way into the *Guardian* this year commenting on the 2016 presidential race¹² and The Macro Tourist Hour on BTFDtv.com just to rant.¹³ (I’m still waiting for *Cosmopolitan* to ask for comments about beauty products.) As this review is being uploaded, I am scheduled to do an interview with Erin Ade on *Boom Bust* (Russia Today), which should be uploaded concurrently on YouTube.¹⁴ This fall a bunch of Cornell undergraduates invited me to be a “distinguished lecturer” on economics *not* chemistry. Apparently, they don’t follow Matt Yglesias on Twitter. With that said, a gallant defense of my honor came by e-mail:

“I can think of no one better than you, Dave, to fill the void of an increasingly undistinguished profession of economists. They have excellent judgment at Cornell.”

~Stephen Roach, Yale and former executive director at Morgan Stanley

Why would anybody give a damn what an organic chemist thinks about investing, economics, and politics?¹⁵ I’m baffled. As a half-hearted defense, in over 34 years of investing with a decidedly lopsided portfolio, I have had only two years in which my total wealth decreased in nominal dollars. My 14-year

return since 01/01/00 is 9% compounded with no leverage and no glass eye. (We all made money in the 90's so I don't even go there.)

Each review begins with a highly personalized account of my efforts to get through another year of investing, which is followed by an overview of 34 years of investing. I thought maybe I would drop the former, but I couldn't because one of my two losing years was this year. Come again? You lost money *this* year? Yep, I'm the guy—an urban legend in the flesh. You cannot teach this kind of prowess. It was a *very* expensive year to be in the Church of Austrian Economics and Hard Assets. Thus, I must continue with the personal overview as a form of a trip to the confessional. The investing section may be instructive for those interested in my approach and for gold bulls on suicide watch. The bulk of the review, however, describes thoughts and observations—the year's events told as a narrative. The links are copious, albeit not comprehensive. Some are flagged as highly recommended.

I try to avoid themes covered amply in my previous reviews. I won't pick on the Roth IRA anymore (although I was right),¹⁶ and I've left resource depletion alone (it's still a problem). Nonetheless, some gifts just keep on giving. Debt permeates all levels of society, demanding comment every year. Precious metals are a personal favorite. This year seems to be more about politics and less about economics. Sections entitled Baptists, Bankers, the Federal Reserve, and Bootleggers describe the players involved in the biggest battle since Frodo melted down the ring for beer money. Society is juiced on easy money, leaving some of us breathless. I finish with a book list that shaped my thinking.

Every year I have declared with an increasingly shrill voice now inaudible even to dogs that civil liberties must be protected at all costs and that we all should avoid using "conspiracy" as a pejorative term. Oh...my...God! Just as smartphones have put to rest the existence of Yeti, aliens, and the Loch Ness Monster, 2013 put to rest any claim that conspiracies do not exist. If you denounce conspiracy theories and conspiracy theorists to me, I will remind you of the quote from a 20th century philosopher:

"Everybody has a plan until they get punched in the face."

~Mike Tyson

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Investing

“People only want to be contrarians when it’s popular.”
 —Rick Rule—

I have changed almost nothing consequentially in my portfolio year over year. I still split my retirement contributions into cash and energy equities. Rebalancing was achieved primarily by the brutality of market forces:

	<u>12/31/12</u>	<u>12/31/13</u>
Precious metals et al.:	52%	41%
Energy:	15%	21%
Cash equiv (short-term):	30%	34%
Other:	3%	4%

My portfolio was dragged underwater in January by the continuing bear market in precious metals and is now swimming with bottom feeders. In a relatively rare instance, but for the second year in a row, an overall return on investment of -17% was beat by the S&P 500 (22%) and Berkshire Hathaway (28%) in what was *not* a photo finish. (Stevie Cohen had a better year.) As a reminder, however, for the second year in a row, the majority of the return on the S&P was p/e expansion, and according to Forbes, “More than 100% of equity market gains since January 2009 have taken place during the weeks the Fed purchased Treasury bonds and mortgages.” We’ll return to this risk later.

My precious metals are distributed in approximately three equal portions to the gold-silver holding company Central Fund of Canada (CEF), Fidelity's precious metal fund (FSAGX), and physical metals. The carnage is amply illustrated with a plot of GLD versus the S&P 500 (Figure 1). Unlike last year when significant metal gains offset losses in the equities, this year they all just tanked with negative returns in gold (-25%), silver (-33%) and precious metal-based equities (-50%). The metal-equity bear market continued unabated, baffling the hard-asset crowd. Did I overstay my welcome in the sector? It's hard to say with my crystal ball in the shop, but the precious metal market was fascinating this year, and I remain a believer in the secular bull (albeit with white knuckles and wobbly knees; vide infra).



Figure 1. Precious metal-based indices GLD versus S&P.

A basket of Fidelity-based energy and materials funds afforded 14–24%. They are represented emblematically by the XLE spider (19%) and XNG Amex natural gas index (21%) in Figure 2. I am wildly bullish on natural gas for reasons discussed in detail three years ago.³ Not only have the equities become rather perky, but Fidelity finally fired a profoundly underperforming manager in its natural gas fund (FSNGX). I keep adding to an already chunky position. America's fleet of trucks is starting to transition aggressively to natural gas; that's illustrative of what may be a global shift toward natural gas that should reward patient investors.



Figure 2. XLE (green) and XNG (red) versus S&P 500 (blue).

Cash was in a U.S. Treasury-backed money-market bunker returning the repressive rate of 0%. This seems like a near certainty. To say I am pissed off at the Fed for rendering my hard-earned and diligently saved capital worthless in the open markets because they are providing capital in unlimited quantities would be a grotesque understatement. I don't have enough venom to heap on the Fed. I could care less what risky horsemeat Bernanke wishes I would buy, more people have been killed reaching for yield than at the point of a gun. Bonds will eventually become *the* story. Those who are pair trading—long bonds/short brains—will be carried away on boards.

I care deeply at a personal and moral level about my family's savings rate. It was difficult to assess this year because I went longer real estate with the purchase of a new house (Figure 3) further confounded by some one-off gains. (I've invited everybody on Twitter to party on the lake this spring.) If we back out the "items", even with the last full calendar year of college tuition—spike ball, end zone dance—we were on track to save approximately 22% of my gross income, which compares with a troubling 11% in 2012 and 20–30% in typical years.



Figure 3. View from the new digs.

To understand my lifetime returns, you must understand two unusual premises that have dominated my thoughts and actions. First, you've got to be a true believer to resist being shaken out of good investments or suckered into bad ones. You can sell good investments too soon. There are no guarantees out there (for retail investors). My second premise is that you have to get it right only about once a decade. Only time will tell if I over stayed my welcome in the precious metals and missed the beginnings of a secular bull in the S&P 500.

My variant of such a sequential trek via imbalanced portfolios changed in decadal rhythms as follows:

1980–88:	exclusively bonds (100%)
1988–99:	classic 60:40 equities:bonds
1999–2001:	cash, precious metals, shorts (minor)
2001–2013:	cash, precious metals, energy, tobacco (minor)

My total wealth accumulated through a combination of savings and investment as shown in Figure 4 (redacted dollar amounts.) The years 2008 and 2013 were the only two down years. Berkshire has dropped five years since 1991. A 9% compounded annual wealth accrual beginning 01/01/00 compares favorably to an annualized return on the S&P of 1.4% (ex-dividends) and on Berkshire of 8%.

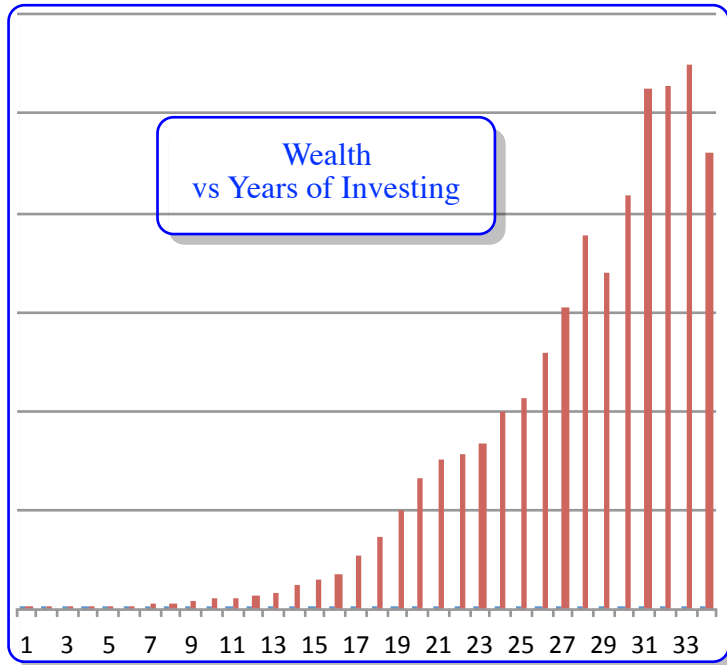


Figure 4. Total wealth accumulated (ex-housing) versus year of employment. Absolute dollar values have been omitted.

To clarify the origins of a 14-year return of 9% per year I offer Figure 5. By plunging into the precious metal and energy sector early and avoiding all other forms of investments (S&P in particular), I was able to capture the entire hard-asset bull market as well as an ensuing cyclical (or secular) bear.



Figure 5. 14-year return on S&P (blue), gold / silver (CEF; green), and energy (XLE; red).

Thinking About Capitalism: The Great Deformation

Given 2013's special role for me as the only grinding bear market I've ever experienced, I will take it right to the hoop by presenting my case for an ongoing secular bear market in equities, bonds, and many other investments that may go on for a decade or more. I will present the case for a secular bull market in gold a bit later. Before doing so, let me do just a little more soul searching.

I suspect that previous readers of my annual reviews may notice a distinct change in tone this year; I certainly do. Despite my best efforts to compartmentalize the issues that are central to defining 2013, the lines seem to be blurring. Are *Broken Markets* the result of *The Federal Reserve*? Is *Government Corruption* eroding *Civil Liberties*?

I am witnessing what David Stockman calls *The Great Deformation*, but are these distortions in the global capital markets inflicted by seemingly horrendous monetary policies or in *my perceptions*? I've pondered this question for years, but I don't have a definitive answer. I believe that readers who stay finish the review will develop a sense foreboding—the sense that something is lurking below the placid surface. I didn't plan to “penetrate deeper and deeper into the Heart of Darkness”, but it happened nonetheless.

The Bear Case

“I feel sorry for [the bears] because they are simply living in the dark ages of monetary policy theory. They are stuck thinking like witch doctors rather than modern medical doctors.”

~David Zervos, Jefferies economist

“By 2030, our calculations suggest that the real value of equities will be about 20% higher than in 2010...We do see it as something of a headwind...”

~San Francisco Federal Reserve

As the equity markets were juiced higher and the equity bears became the walking dead, it is obvious why I don't short stocks. But why am I still a secular bear? Of course, there are always things that go bump in the night. Some may prove inconsequential bricks in the wall of worry. I will do plenty of bricklaying throughout this document. However, some really big concerns—the monsters under my bed—keep me up at night.

Bonds and Buffett. In 1977, Buffett noted that “It is no longer a secret that stocks, like bonds, do poorly in an inflationary environment.” The quibbling over whether inflation is here continues, but there is little doubt that the hooligans at the Fed are determined to trigger some. The 32-year-old bond bull is long in the tooth, fully priced for an inflation-free world. We have central bankers on a bond buying spree that has the surreal effect of keeping interest rates low by printing money. Of course, these shenanigans will end, and price discovery in bonds will be accompanied by investors' self-discovery. Optimists bray that rising rates are bullish, a sign that the world economy is recovering. In 1999, however, Buffett wrote a compelling article in *Fortune* attributing secular equity

moves to one and only one parameter—the direction of long-term interest rates. Secular equity bull markets occur when long-term rates are dropping—not low but *dropping*—and secular bears occur when rates are rising.¹⁷ He didn't equivocate. I could imagine him uttering some platitudinous gibberish like, "rising rates sink all boats." When experts say that low rates are bullish they are either doofuses or Buffett has lost it. Buffett is a mafia don walking around in a bathrobe trying to look harmless, but I doubt he has lost it.

So are rates really that low? In a word, yes. I talk about that in the Bonds section. The salad days of the bond market are in our rear-view mirror. The rate bottom and subsequent rise will be global. Rising rates will spread into the markets and economy at large, causing concurrent stagnation, dropping price earnings ratios (from nosebleed Case-Shiller estimates of 24), collapse of credit-fueled / capex-lite corporate profit margins, and crush under-funded pensions and municipalities rendering them less funded. If rates have no where to go but up, what direction are they headed? Thought so. That is the generic monster under my bed.

Demographics and Unfunded Liabilities. The really nasty monster is a Frankenstein-like beast constituted by combining demographics and unfunded liabilities. We can watch demographics play out in living color in Japan. Japan's 24-year-old lost decade is often attributed to inadequate intervention by central bankers and policy makers insufficiently armed with untested theories of academic economists mired in state capitalism. The Japanese have also been getting old. My Cornell colleague Rich Marin, former CEO of Bear Stearns Asset Management and author of the newly released *Global Pension Crisis*,¹⁸ estimates that Japan will demographically bottom out with one worker for every three retirees. You can fiddle with dollars, cents, yen, GDP, JGBs and savings estimates all you want, but the demonetized reality is that Japan will have one worker providing all the goods and services for *four* people. Kyle Bass is right: the Japanese economy is rotting from within.^{19,20}

Well that's gonna suck, but why do I care? That's simple: we're a decade or two behind Japan but making up ground fast. We've promised boomers a **butt** boat load (spouse edit) of benefits in their old age. Kotlikoff, Burns, and Smetters,²¹ in cahoots with Secretary of the Treasury Paul O'Neill, set out to wrap their brains around the unfunded liabilities—promises made which, after subtracting reasonable estimates of revenue streams, we haven't a clue how we will cover. Kotlikoff now estimates that they total \$205 trillion.²²

Some readers have heard this number but precious few can grasp it. \$205 *trillion*? Let me do another demonetization. Assuming that there are 100 million taxpayers to pick up this tab and that the average taxpayer contributes *50% of their \$50,000 per year salary*—a preposterous payment schedule—how long will it take to pay off these liabilities? The answer is...wait for it...80 years...80 friggin' years...8 decades...four score... 8.0×10^1 birthdays...*a lifetime*. Maybe Kotlikoff had an Excel fail; there's been a lot of that lately. I think he's great, but he *is* an economist. I've seen estimates as low as \$70 trillion. That cuts the burden on taxpayers living on half-salary to a mere 25 years. As Marin said in a recent seminar focusing only on the pension component of the problem, "I am trying desperately not to be apocalyptic." Good luck with that one Cheech. Now would be a good time to panic.

The Economy

1%: "Our economy is doing very well."
99%: "We're very happy for you."

Nothing is more difficult than teasing economic facts from the fiction being marketed daily. Dow watchers would claim we are at all time highs and, because markets are "forward looking," we must be doing well. Others would call that a total crock. Even the most optimistic must admit that those down the food chain are less enamored with our current recovery. This section will necessarily have a left-wing, Elizabeth Warren feel to it. I don't think she is a wealth redistributor, and I know that I am not because I (still) have some to distribute. However, a healthy economy probably distributes wealth in a rational (possibly even predictable) fashion, and I very much doubt we are observing that now. History shows that dismissiveness directed at expanding impoverished masses can have dire consequences. The 1% who suggest that the 99% "eat cake" are likely to eat it metaphorically. I don't recommend we redistribute wealth, but we should be deeply concerned about how it is distributing as a possible symptom of a failing state. Some of the symptoms are mentioned in this section. Debt gets its own sections.

Corporations. To start with some good news, corporate balance sheets are said to be in unbelievable shape. I find this perplexing given that my arithmetic shows the Dow 30 is \$500 billion in the hole (cash minus debt). Maybe I am missing other financial assets, but I wonder whether the balance sheets are filled with borrowed money. We are also told with considerable glee that corporate profit margins are breaking all-time records (Figure 6), possibly up to 70% above the historical averages.²³ This, unfortunately, is very bad news because profit margins are notoriously mean regressing. Picture a 70% *mean regression*. Now picture the inevitable and mandated overshoot (or it wouldn't be the mean). Profit margins are propped up by cheap capital courtesy of the Fed, lower numbers of employed workers (euphemistically called increased efficiency), savings from increasing numbers of benefit-free, part-time workers, and a total lack of wage pressure by those fully employed. Corporate capital expenditure (capex) is near zero,²⁴ supposedly to fund dividend payments (although fungibility of money makes that connection dubious). Regardless of motivation, cutting back on capex is eating your seed corn. At some point the pipeline of innovation runs dry. I was struck by the news that Merck faces pressure from generic drug companies. Their response? Buy back shares.²⁵ My head hurts. Corporate profit margins will naturally shrink. If workers begin to enforce some wage inflation into the equation, the regression of profit margins through the mean could be dramatic. The margins will collapse like a dream sequence in *Inception* as the fruits of research and development will not exist.

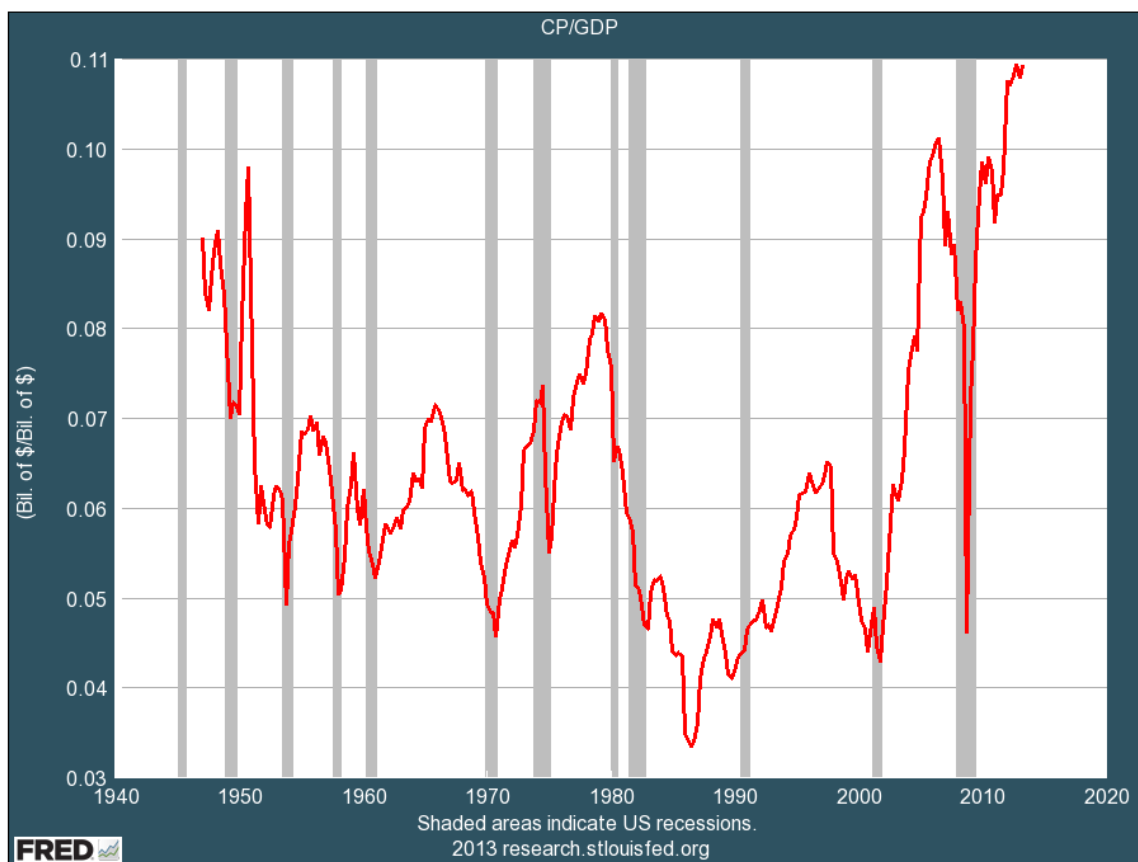


Figure 6. Corporate profit margins

"Facts do not cease to exist because they are ignored."

~Aldous Huxley

Employment. Few stats are more cooked than the employment numbers from Bureau of Labor Statistics (BLS). The former head of the BLS estimates that the reported unemployment numbers are about 3% higher than the reported estimates.²⁶ This year they got really creative by "forgetting" to include California's numbers five months in a row.²⁷ Some estimates exceed 20%.²⁸ The departure of workers from the workforce, whether voluntarily or by discouragement, often greatly exceeds the number of new jobs; the participation rate is not a pretty picture (Figure 7),²⁹ but it may be more instructive with which to view unemployment. As a reminder, each percentage point on the y axis in Figure 7 represents approximately 2 million workers no longer employed or seeking work. The labor participation rate is deceptive in that it suggests we were here pre-1980, and our world continued to rotate on its axis (albeit with serious stagflation). However, any further drop begins to dig into the gains made by women entering the workforce in droves. That distant era only worked well because men were paid enough to raise a family on a single income, most had full-time rather than part-time employment, and college grads weren't doing jobs requiring name tags. Figure 7 also does not include the boomers exiting the work

force en masse; that is just beginning this year. Of course, we are assured they will work till they drop (or are released in a corporate downsizing to increase productivity).

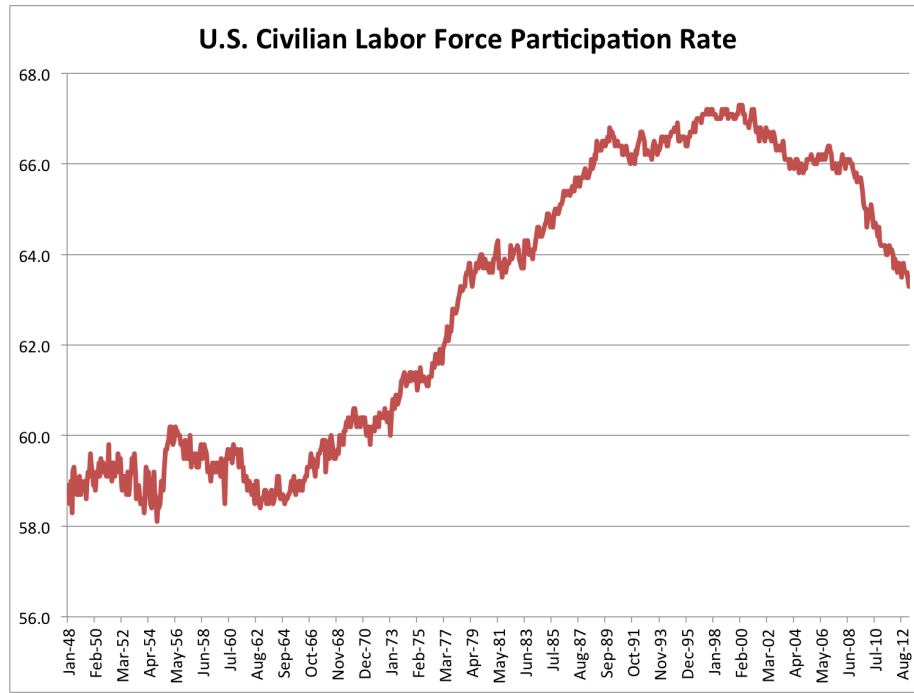


Figure 7. Long-term labor participation rate.

The raw employment data are staggering. Grant Williams, for example, has noted that the heralded 236,000 job gain reported in one month included over 400,000 part-time jobs (without benefits).³⁰ Although the headlines report job growth, we actually lost 276,000 full time jobs (with benefits). An estimated 77% of new jobs are part time.³¹ Only 47% of adults have full-time jobs. An estimated 100 million working-age people are not working—100 million.³² As we row this Roman galley of an economy through turbulent seas, only half the crew are pulling on the oars.

Household Stress. Median household income in the United States has fallen for four consecutive years. Over 50 percent of all American workers now make less than \$30,000 a year.³³ Forty percent of all workers in the United States make less than what a full-time minimum wage worker made back in 1968.³⁴ A record and monumental 50 million people are on food stamps.³⁴ Wal-Mart leaked a story of decaying fundamentals.³⁵ (The Wal-Mart executive who leaked the info decided to spend time at the unemployment office.³⁶) Watch the malls: many are using the Potemkin Village ploy—putting in unstaffed fake stores such as the “Garden Tractor Store”—for show.

“Money doesn’t make you happy. I now have \$50 million, but I was just as happy when I had \$48 million.”

~Arnold Schwarzenegger

Wealth Disparity. Measures of wealth disparity are legion. The income growth at the top end of the earnings curve has soared by comparison, eliciting the 1%/99% nomenclature quoted at the opening.³⁷ The net worth at the top has also soared whereas the “net worth” changes sign in the bottom deciles. Sales of high-end collectibles (such as impressionist paintings that I think are grotesquely overrated and certainly oversupplied) are busting records at Sotheby’s and Christies.³⁸ Prices are *not* being driven by the builders of empires—Dell, Gates, Ellison—but by guys who move money for a living. This is what Kevin Phillips called “financialization” of an economy, the most prominent hallmark of empires about to exit through a non-revolving door.³⁹

“Something is structurally amiss when so much financial activity is borderline.”

~anonymous hedge fund manager

Marginal Activities. Guided in large part by the Austrian business cycle theory,⁴⁰ I view serious risk residing in marginal activities—businesses that are only profitable in the most unhostile of environments. What happens when inflation rears its ugly head? Evidence suggests that it is already here. The levies could give way with little warning, leaving the Sorcerer’s Apprentice (the Fed) trying to mop up the liquidity. We have had a stay of execution owing to record low money velocity (Figure 8), but that will change. What happens when the free market asserts itself as it *always* does and rips control of interest rates away from central bankers? Marginally profitable businesses built on foundations of cheap credit will show the life expectancy of a soufflé in an earthquake. My dad once told me that the capital-intensiveness of his construction company protected him from capital-deficient goofballs entering the game and putting valid financial concerns out of business. Those protective walls don’t exist anymore. When the next recession comes—we are currently at about the median duration of an albeit feeble expansion⁴¹—it will hit an economy that is immunocompromised (Figure 9). Marginal businesses will be eviscerated as will some that should have survived.

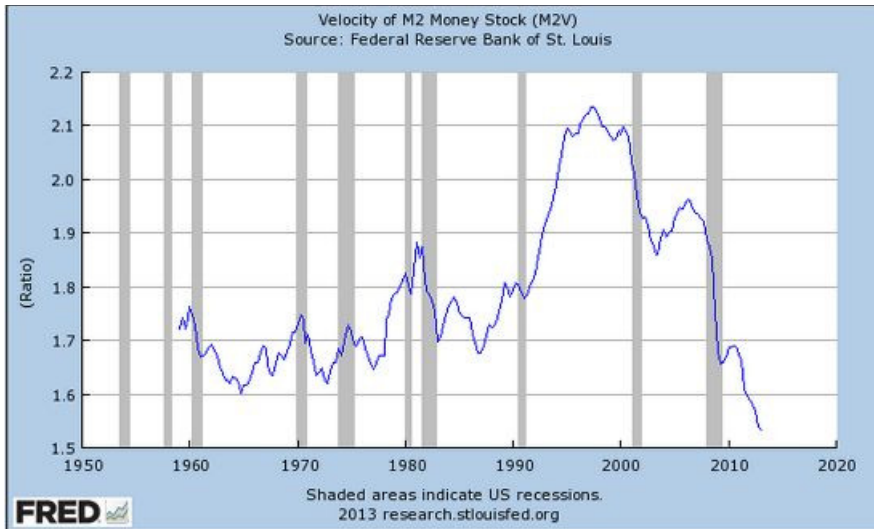


Figure 8. Velocity of M2 money stock.

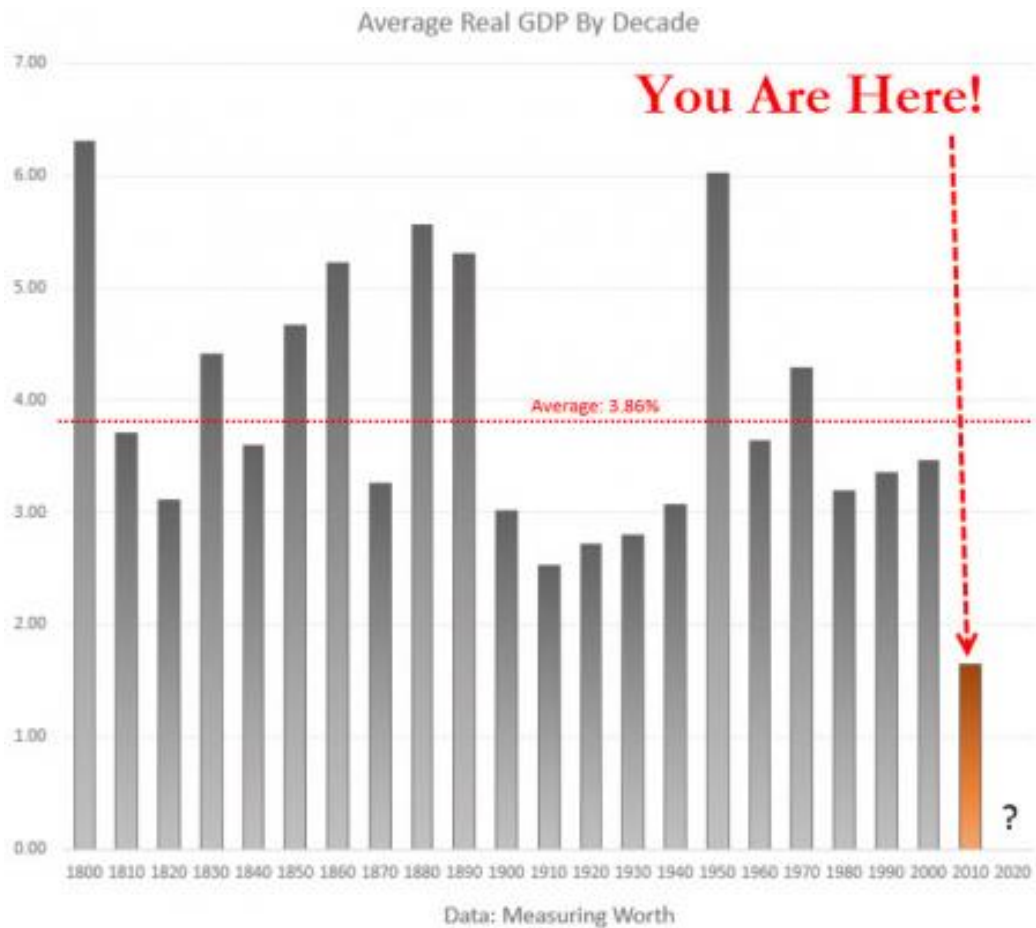


Figure 9. GDP over time.

This naturally brings me to a point that I've been meaning to make for years: Can you have too much creative destruction? Of course, replacing the dilapidated and inefficient old with new and improved variants—the epitome of creative destruction—is capitalism at its finest. Nobody will scream louder than buggy whip makers caught in the path of creative forces, but those screams should fall on deaf ears. There is a point, however, at which the hyperactive replacement cycle of durable goods becomes malinvestment—too many intermediate generations en route to the refined product. Disagree? Bulldoze your house every 10 years, and replace it with a better one. How would that work out? The replacement cycle may be cycling too fast. If so, I blame aggressive monetary policy fostering an economy that is flailing, owing to marginal activities.

Broken Markets

“Every financial asset is artificially priced.”

~Mohamed El-Erian, Pimco

“All risk asset prices are artificially high.”

~Bill Gross, Pimco

I guess we know where Pimco stands. This year we celebrated efficient markets by giving the Nobel Memorial Prize in Economics to Eugene Fama, Robert Shiller, and some other guy. Fama made it big by building a model showing that markets are omniscient, including everything possible to get to the right price by definition. Shiller showed Fama's theory was hooey. I guess this is the Cassius Clay–Sonny Liston model—somebody had to get knocked out to make history. The third guy probably did something arcane. Let's look at how these efficient markets did this year.

Overvaluation. Who's to say that markets are under- or overpriced? The price is the price, right? Two New York Federal Reserve economists delivered a paper concluding that U.S. stocks were as cheap today as any time in history,⁴² which is a little odd given they were 60% cheaper in March 2009. Although the world equity markets rise, the GDP is looking a little green around the gills (Figure 10).⁴³ You can graphically overlay anything on anything and say anything, but Figure 10 does seem to say something.

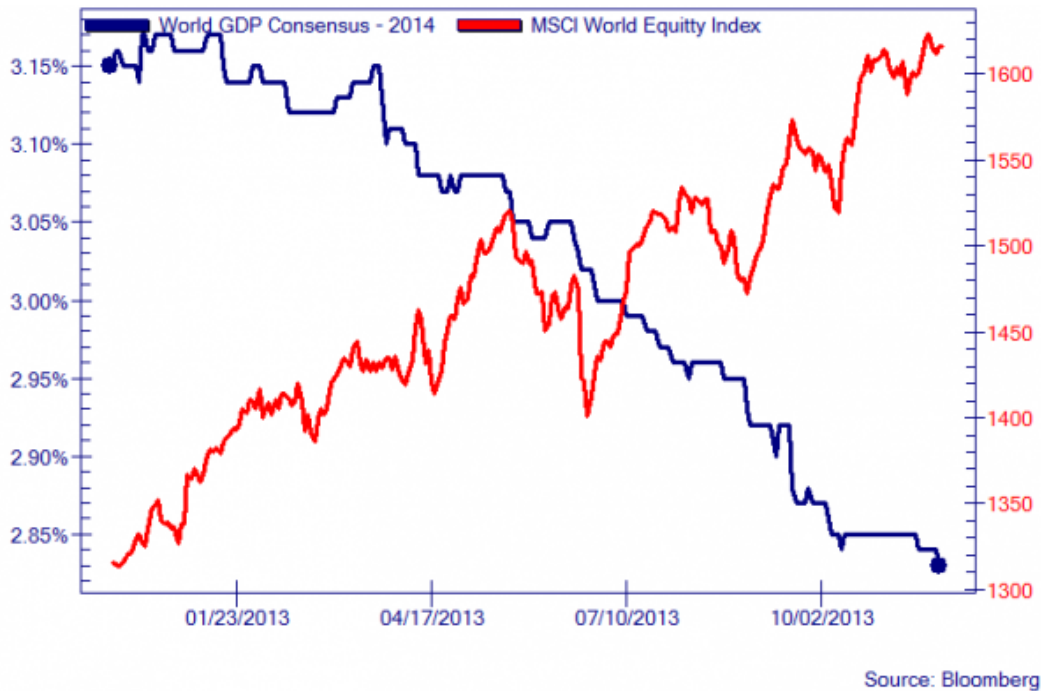


Figure 10. World GDP and equity prices.

Let's focus on the U.S. forward-looking earnings, which are said to appear reasonable. Of course, these earnings do not exist except in the minds of optimistic analysts. By contrast, the Case-Shiller p/e using time-averaged earnings is in the scary 24 zone.⁴⁴ John Hussman, a brilliant analyst who must be losing clients by the scores owing to his attempts to protect them, suggests bear market bottoms occur at a Case-Shiller p/e of about 8.⁴⁵ The S&P 500 price/revenue ratio of 1.6 is twice its pre-bubble historical norm of about 0.8. (The 1987 peak occurred at a price/revenue ratio of less than 1.0.) The Russell 2000 is now sporting a p/e of 40 using 2014 fabricated earnings but a p/e of 60 times trailing earnings.⁴⁶ Stockman says that by excluding charges—"ex-items"—companies fabricate an additional 30% to the earnings numbers. You can find distortions of comparable magnitude by using the forward earnings that are invariably *waaaaay* too optimistic.⁴⁷ *As the forward earnings become discredited by reality, analysts quickly switch to the following year's forward earnings.*

There are smart guys questioning whether price discovery is working (Fama aside). Jeremy Grantham, the wise old man with \$150 billion under management, puts fair market value on the S&P 70% below the current levels,⁴⁸ coincidentally the same percentile as the bloated profit margins. Cliff Asness, looking across all markets, concludes that "the 60-40 portfolio has been cheaper than it is now 98% of the time."⁴⁹ (Cliff wins no award for direct prose.) David Einhorn notes that "the S&P 500 index has advanced this year mostly through multiple expansion"⁵⁰; the gains of 2012 were all multiple expansion as well.⁵¹ Are the distortions attributable to "ex-items" and "forward earnings" additive? I don't

know, but Peter Boockvar summed it up nicely: “There is 0% chance this ends well.”⁵²

We’ve created *another* equity bubble? It certainly tracks to the global central bankers massive monetary infusions—add Mentos to Coke and shake vigorously. Margin debt is soaring (Figure 11).⁵³ I’ve had arguments about whether the tracking of margin debt with equity prices is causation or merely correlation. I actually don’t care. If both correlate with groundhogs popping their heads up, I’m keeping both eyes on the ground hogs. By the way, that previously mentioned wall of worry is unsupported by the technically relevant statistic that the number of equity bears just hit a greater than 25-year low (probably *much* greater than 25 years).⁵⁴

When career risk forces managers to buy an asset class, it is time to sell that asset class.

Are we there yet? Jeremy Siegel thinks earnings are being *underestimated*—yes, you read that right—making the market only *appear* expensive. That, folks, was a groundhog sighting.

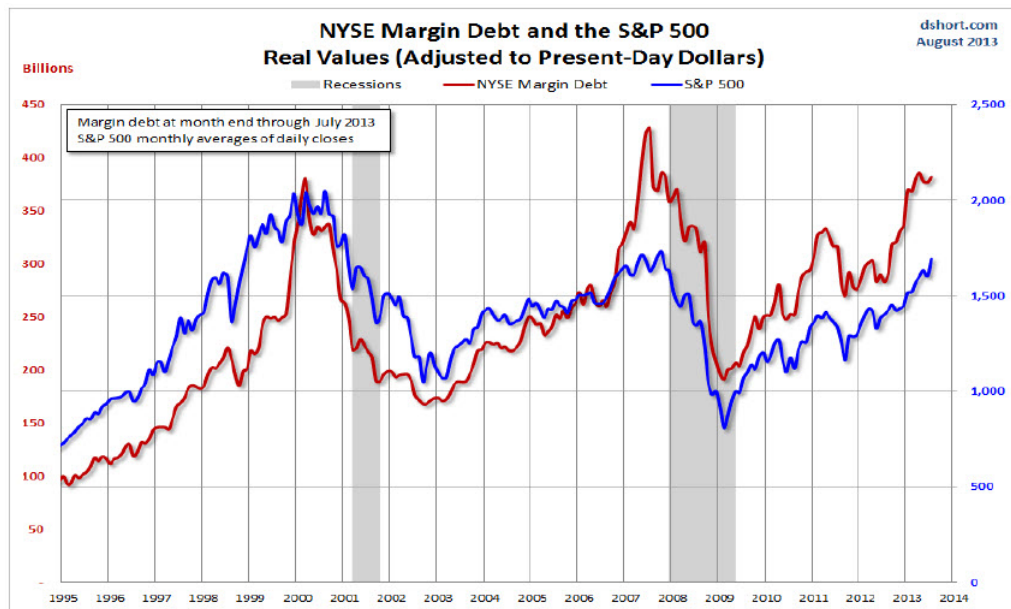


Figure 11. Margin debt (red) versus the S&P 500 (blue).

“Oh, my, gosh, that’s amazing, and so easy. I have to do this.”
~16-year-old day trader and soap opera actress

Bubble Behavior. Einhorn suggests that “when ‘high short interest’ becomes a viable stock-picking strategy and conventional valuation methods no longer apply for many stocks, we can’t help but feel a sense of déjà vu.”⁵⁵ Of course, he was probably thinking of Green Mountain Coffee (GMCR), which is an Einhorn

short and is up 100% this year and 200% off its 2012 lows. Einhorn knows where the bodies are buried. This is a classic squeeze of traders who follow his lead but lack his patience. Other stocks that popped up like Uma Thurman include Tesla (320%), BestBuy (250%), and Fannie Mae (1000%). Those are *year-to-date gains*. Tesla's market cap (\$20 billion) and number of cars sold (35,000 per year) corresponds to >\$500K per car. Netflix is now sporting a p/e of 200, causing value investors to wince and momentum traders to just keep on clicking. Amazon.com shares are up 60% since 2011 whereas their revenues have fallen 50% over that same time period.⁵⁶ Shares in Tweeter, a bankrupt electronics retailer, briefly soared 1,800% on October 4th because some investors mistook its ticker symbol TWTRQ for TWTR, the shorthand chosen by Twitter ahead of the IPO. An NFL running back IPO'ed himself.⁵⁷ Running backs have career expectancies of four years, which may put his IPO life cycle above average.

The stellar performer, however, was Bitcoin, everybody's favorite virtual currency, starting the year at \$13 per Bitcoin. And then it ran...and ran...and ran. A return of 100% *in 15 minutes* was upstaged by a *100-fold* jump in the first 10 months of 2013 by mid November, at which point "profit taking" looked like it would cause Bitcoin to hurtle back to Middle Earth (65-fold as of ten minutes ago). Alas, Bitcoin took flight again, eventually attaining parity with an ounce of gold and causing some to equate the two. *We are watching history being made or history being repeated*. Although I endorse what Bitcoin represents—opposition to fiat currency—I am deeply skeptical of its success. I can, however, imagine a nickname if it tanks.

Flash Crashes and Market Glitches. Last year we had some stellar market glitches; although Facebook got the press, the complete annihilation of BATS and Knight Trading brought comedic flare. This year was tame, but daily flash crashes and glitches documented by Eric Hunsader *et al.* at the research firm Nanex became truly voluminous.⁵⁸ Hunsader's documentary entitled, *The Wall Street Code* starring high frequency trader (HFT) Haim Bodek is worth a peek.⁵⁹

The Nasdaq kept going dark for anywhere from a few seconds to a number of hours, inspiring Zerohedge to anoint it the Nasdark. Some blackouts seemed to be tied with trading in Apple shares.⁶⁰ Goldman reported a slew of bad trades (defined as any trades that lost Goldman money), which were immediately followed by a big-time Nasdark.⁶¹ Not to worry: Goldman got the trades unwound. In some cases, envoy-class traders still managed to adjust their portfolios while everybody else was blocked out.⁶² That probably included Goldman. Fannie Mae did a 50% spike and return,⁶³ all on low volume in 15 minutes. Industrial conglomerate Tyco did a sub-second 10% face plant.⁶⁴ Natural gas flash crashed 8%.⁶⁵ This is all in good fun. If you haven't done so already, listen to Ben Lichtenstein giggling his way through the May 6, 2010 Flash Crash.⁶⁶

Algorithmic Trading. This frothy market behavior emanates from the Federal Reserve's perverse monetary policy in collaboration with algorithmic trading platforms ("algos") guided by HFTs—*Algos Gone Wild*. Hunsader has been trying to alert the SEC but failing for a very simple reason: the SEC is worthless. For years now the algos have been *illegally* carpet bombing the markets with fake quotes designed to disrupt trading. Up to

4% of the quote volume can be caused by a single algorithm sending digital sonar signals.

Hunsader realized that the HFTs in Chicago were trading off news emanating from New York *faster than the speed of light could transfer the news*.⁶⁷ He concluded that the traders were getting advanced notice and hiding this edge by trading in the narrow window between the release in New York and the arrival of the news in Chicago seven milliseconds later.⁶⁸ The story got national press, prompting Larry Kudlow to exclaim, “All I know is the speed of light is seven milliseconds.” I concur with Larry: that is all he knows, and its a preposterously foolish statement. Advance notice to the big traders of key economic statistics kept popping up and could have been a big scandal but, like all big scandals on Wall Street, it went away. If ever there was a market strategy poised to give up all advantage to arbitrage it would be algorithmic trading, and it seems to be happening. So what do they do now? HFT carries started marketing algorithmic trading to the masses!⁶⁹ This ought to kick start a few pension funds, eh? There is a movement afoot, however, to contain the algos. Italy put a nominal tax on each trade to make the high-volume fake trades unprofitable.⁷⁰ Think about that one: Italy is ahead of the U.S. in combating organized crime.

Odd Chart Patterns and Rigged Markets. Charles Schwab, unlike Scott Trade, is a real person who exclaimed that “we are in a manipulated market.” Whereas Nanex focuses on microsecond time-scale patterns that would trigger a Peter Max-quality flashback, I find some of the lower frequency oddities interesting. A favorite is the ramp ‘n’ camp in which indices rise and park on a price (Figure 12). The mirror image to the downside is the drop ‘n’ flop. I’ve exchanged many a Tweet with Joe Saluzzi, author of the book *Broken Markets* and veteran trader, hooting about these common occurrences. I seem to be uniquely—as in all alone—enamored with the invisible hand of the market on the S&P (Figure 13). That thing moves with the natural grace of a marionette. The fingerprints of Adam Smith’s invisible hand are indicated with red asterisks. I guess it is ping-pong some trend line.



Figure 12. Ramp 'n' camp of the German DAX without an associated news event.



Figure 13. The S&P 500 for 2013. Asterisks indicate whatever.

Where's all this coming from? Maybe it's the flow of money into ETFs (Figure 14).⁷¹ Ignore the green line; it's normal behavior for a market in the midst of a five-year selloff, which didn't occur. Put a straight edge up to that yellow curve: Can you imagine the R-factor? Is the invisible hand guided by the President's Working Group on Financial Markets?⁷²

Equity Holdings Shift From Funds To ETFs

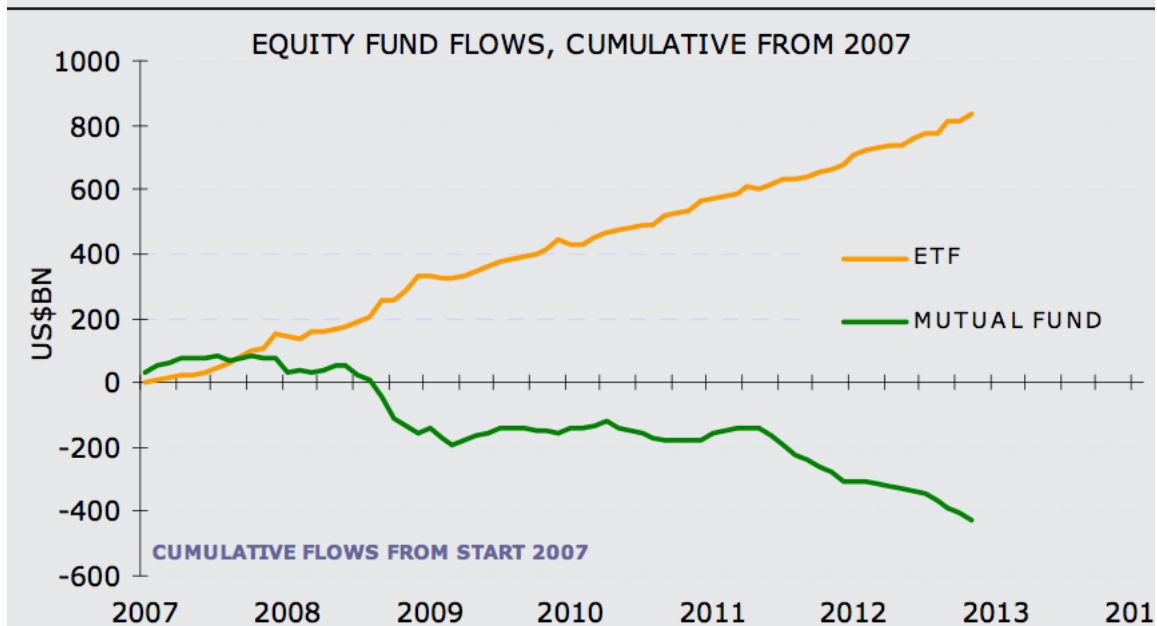


Figure 14. Flows in and out of mutual funds and ETFs.

This is all just conspiracy theory crap. The definitive word on odd market behaviors is provided by the SEC:

“Most rapid price spikes are caused by old-fashioned human mistakes, such as ‘fat finger’ errors, where a trader may accidentally add an extra zero to an order, or by portfolio managers accidentally requesting a large order be immediately executed rather than meted out in a managed flow. Contrary to public speculation, these types of events do not seem to be triggered by proprietary high-speed algorithms, by robots gone wild, or by excessive order cancellations.”

~Greg Berman, associate director of the Office of Analytics and Research in the SEC’s Division of Trading and Markets

I stand corrected.

Gold

“Gold bugs are frequently jerks. This [drop] vindicates the economic ideas of the economic elites.”

~Joe Weisenthal, *Business Insider*

“ The [gold] bull market is broken, the prior narrative has utterly failed, and is no longer taken seriously, except by yellow metal jihadists and other assorted suckers.”

~Barry Ritholtz

“There’s a clique that enjoys pointing out the pain in gold as it goes down.”

~Art Cashin

The gold bear that began in 2012 marches on, and the detractors were braying the whole way (sigh). It is the first bear market that I’ve personally ever witnessed from the inside... prostrate...under a bridge...stewing in my own vomit. Gold may be *the* story of 2013, but not for the reasons that many believe. Grant Williams posted an interesting graphic showing that gold’s dozen-year run turned south when Venezuela repatriated 100 tons (Figure 15; left vertical line). It turned downright fugly when Germany demanded gold be repatriated (Figure 15; right vertical line) from France *immediately* and from the United States whenever it can get it, which the U.S. interpreted as within seven years (maybe).

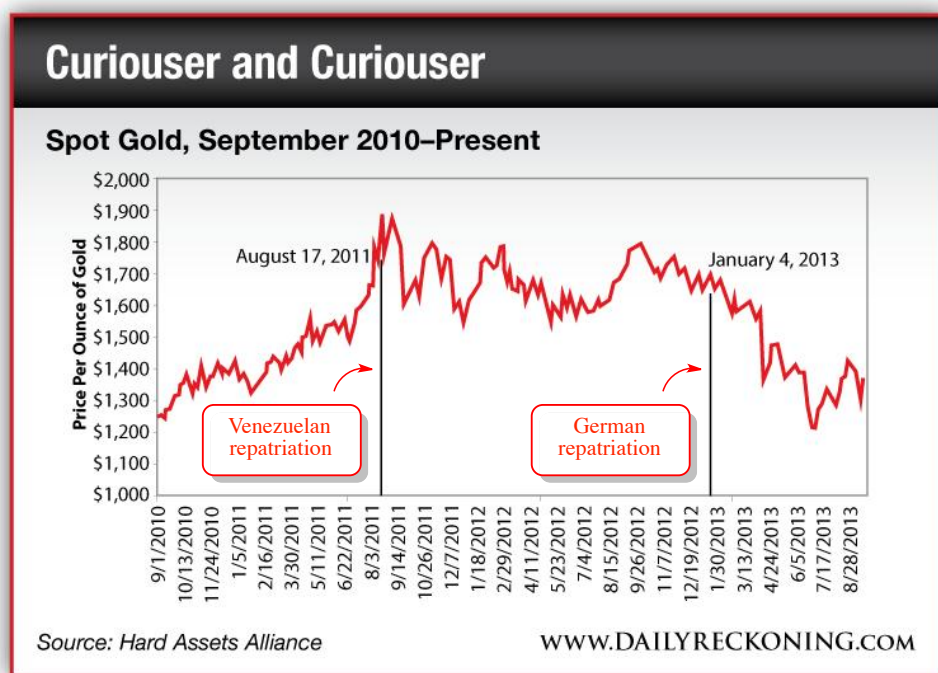


Figure 15. Gold price showing vertical lines corresponding to Venezuela and German gold repatriations (first created by Grant Williams).

The price of gold spent all of 2013 in a state of continuous carnage. Reporters breathlessly reported tonnage being liquidated from GLD, Comex, Brinks, JPM, and other gold depositories (Figure 16).⁷³ (Comex disclaims their numbers as fictional.⁷⁴) The Hong Kong Metals Exchange was liquidated and closed.⁷⁵ ABN Amro and Rabobank defaulted,⁷⁶ telling customers that their allocated gold had

been rehypothecated (sold or leased out with no chance of getting it back), and payment would be in cash—shades of MF Global.

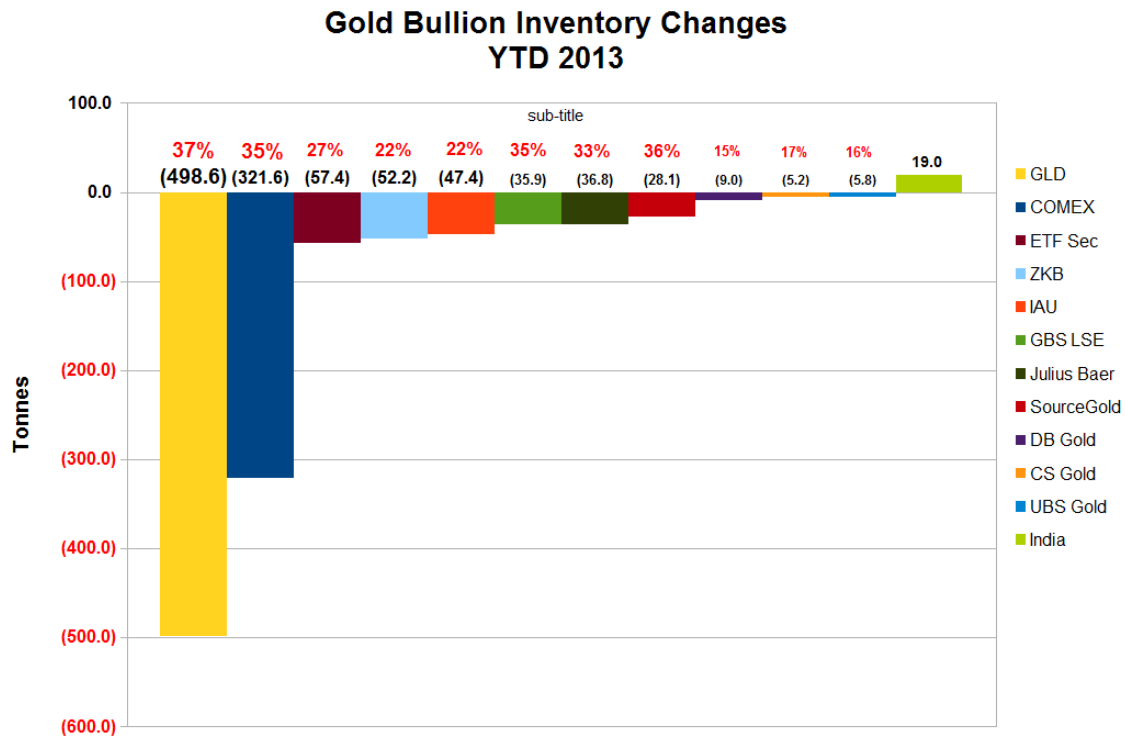


Figure 16. Liquidations care of Jesse’s Cafe Americain. (Jesse was one of the original market bears a dozen years ago.)

It got gruesome when India decided to mitigate their trade deficit and growing inflation problem by suppressing demand for gold in the land of the gold bugs. (Indians are to gold as teenagers are to cell phones.) Tariffs and taxes were explicitly implemented to shut down consumer demand.⁷⁷ Indian authorities discussed setting up a GLD-like ETF to shunt consumer demand away from physical gold.⁷⁸ *Reread that last sentence.* Proposed bans of gold coin sales were followed by the eventual shutdown of the Indian metals exchange.⁷⁹ Premiums on physical gold soon soared as the Indian gold market became a classic black market with smuggling rising >300%⁸⁰ (and a spike in the sales of body scanners and anal probes.) The authorities discussed selling sovereign gold into the open market to “strengthen the rupee”,⁸¹ but decided that such logic was completely backwards and moronic—a form of quantitative easing (QE) currency debasement Indian style. Indian commercial banks were directed to purchase gold from consumers.⁸² The authorities reserved their special place in Hell by threatening to confiscate the gold acquired over millennia by religious organizations.⁸³

India wasn't alone. France banned the sale of gold and silver by mail.⁸⁴ Vietnamese authorities forced banks to charge for gold storage⁸⁵ and appears to be heading for gold confiscation.⁸⁶ Thailand, Pakistan, and Syria all jumped in to suppress the demand for gold from the retail markets.⁸⁷

April was the global organ harvest for the gold bulls, yielding remarkable crop to the gold shorts wielding rusty butter knives. Snippets of bearish news just kept rolling in, but I couldn't grasp what I was sensing. As the price dropped China kept buying, importing record amounts of gold in March. Soon thereafter, Obama met with bankers (probably on Jekyll Island), and a few days later Goldman tells the world to "short gold."⁸⁸ When was the last time a major brokerage declared an all out short against *any* asset class? (Hint: Never.) After an odd two-day calm, gold got absolutely crushed. We are not talking skittish investors starting to move in concert but a real stampede. Thousands of futures contracts were sold in one second;⁸⁹ billions of dollars worth of futures contracts in 15 minutes; tens of billions in one day.⁹⁰ A single trade of 2 million ounces crashed the CME computers.⁹¹ An unprecedented collapse of the trading platform in the *physical* gold market place and the shutdown of Kitco's pricing mechanism,⁹² brilliantly timed for Sell-off Friday, forced panicky gold bugs looking to hedge for the weekend into the options market, driving the prices even lower.⁹³ The CME decided that was an excellent opportunity to raise margin requirements by 18.5%, which was guaranteed to force more selling.⁹⁴ The Friday glitch-a-thon gave the brokerages ample time to line up their margin calls to ensure selling continued unabated the following Monday. It was pandemonium in the gold markets.

That, folks, was a textbook bear raid, brought to you by Goldman Sachs and heaven knows what other powerful forces. It left serious "technical damage", which is a euphemism for "merciless beatings with baseball bats." A number of summaries of the carnage have been penned, the best of them from Grant Williams.^{95,96}

Throughout the remainder of the year gold sales showed odd patterns, such as high correlations with Japanese debt (JGBs; Figure 17)⁹⁷ and trading in shares of Apple.⁹⁸ Confiscation of Cypriot gold by EU banks—a microstash at best—caused more bone-crunching selling despite the lack of evidence that Cypriot gold would ever see the open market.⁹⁹ The Boston Marathon bombing triggered selling. Yes indeed. It would appear that even terrorist bombings are now bearish for gold. Societe Generale (SocGen) wrote a report declaring "The End of the Gold Era."¹⁰⁰ It appears to be game over for gold, right?

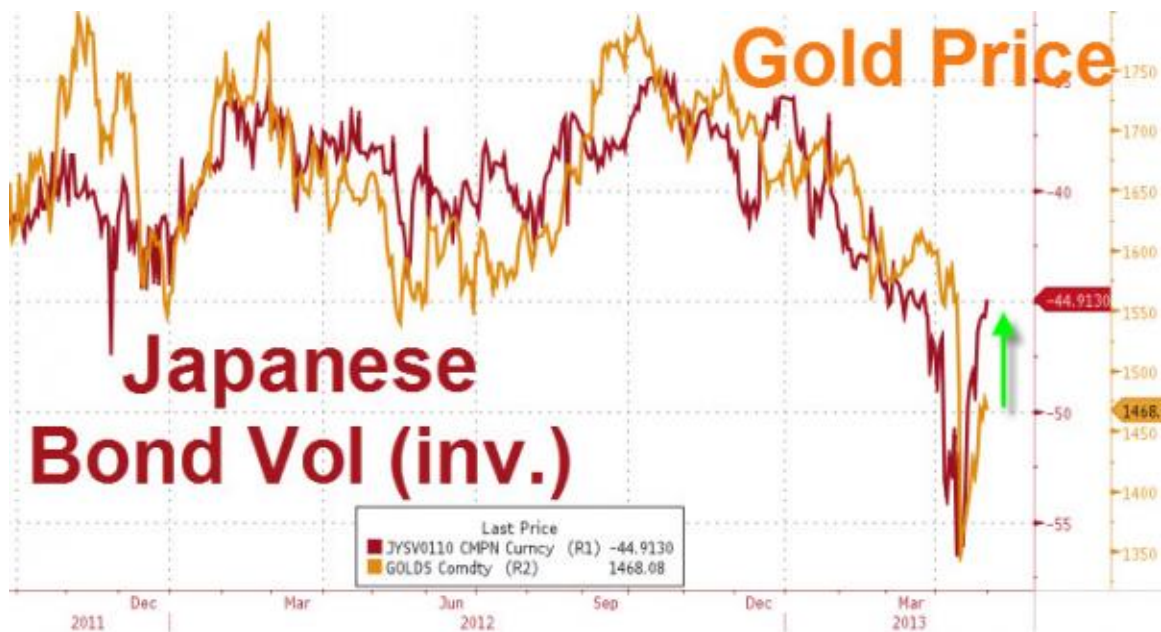


Figure 17. Gold vs JGBs

Are you confused yet? I sure am. Although the sell-off had all the trappings of a panic, much of what I just recounted reflects a huge spike in demand for physical gold, squeezing supply from every nook, cranny, and orifice (quite literally).¹⁰¹ Authorities around the globe seemed to be apoplectic about containing this demand. Asians were panicking too in a different way. Asia witnessed lines around the block at gold dealers that were dominated by buyers, not sellers. The Perth mint was swamped with purchase offers.¹⁰² Even the U.S. Mint broke all-time selling records on the day that the price drop in gold broke records.¹⁰³ The demand for physical gold went bonkers, yet the price just...kept...dropping.

Let's look back at that plot of gold provided by Grant Williams in Figure 15 and reiterate a question he posed: Why would repatriation—demand for hundreds of tons of gold—cause gold to tank? Shouldn't it cause gold to *rise* as authorities scramble to round it up?

I played a minor role in the headline-grabbing liquidation of GLD stockpiles that begins to shed light on what was happening. Tony Deden told me that he and a team of lawyers tried to pry \$60 million dollars of physical gold from GLD; Tony was told to pound sand. I told Grant Williams, he wrote about it, and the blogosphere went nuts, declaring GLD gold unavailable. On further fact checking, I found that Deden's tale of woe was public knowledge in 2007.¹⁰⁴ The so-called bullion banks—the 20 Too Big to Fail (TBTF) global banks—have since GLD's inception been the only organizations allowed to trade shares for gold. They appear to be using GLD as a fractional reserve gold bank,¹⁰⁵ and this year GLD witnessed massive outflows. Let me restate that: *The banks traded in vast reams of paper gold for physical gold.* Hold that thought.

The horrifying gold sentiment within the investing community at large is captured in these quotes from the *New York Times*:

“There is simply nothing in the economic picture today to cause a rush into gold. The technical damage caused by the decline is enormous and it cannot be erased quickly. Avoid gold and gold stocks.”

~NY Times

“Two years ago gold bugs ran wild as the price of gold rose nearly six times. But since cresting two years ago it has steadily declined, almost by half, putting the gold bugs in flight. The most recent advisory from a leading Wall Street firm suggests that the price will continue to drift downward, and may ultimately settle 40% below current levels.”

~NY Times

“The fear that dominated two years ago has largely vanished, replaced by a recovery that has turned the gold speculators’ dreams into a nightmare.”

~NY Times

Thousands of quotes like these appeared online all year. *The above quotes, however, are from 1976.*¹⁰⁶ They were precipitated by a 50% drop in the spot price of gold (\$200 to \$100 per ounce. Ouch.) The headlines were followed by an epic *eightfold* gold run from \$100 to \$850 an ounce. It might have continued if Paul Volcker hadn't risked turning his name into a verb to gain control of global markets. You've got to wonder who was calling the shots at the Times.

For every seller there is a buyer, but who were the buyers? The jerks in China! (See Figure 18.)¹⁰⁷ China even purchased the golden goose—the London Metals Exchange.¹⁰⁸ India, Korea, Russia, Mongolia, Switzerland, and several dozen mostly Asian buyers joined the buying spree via their central banks (Figure 19). Even the People's Republic of Texas did some serious repatriating, prompting Rick Perry to declare, “We don't want just the certificates. We want our gold. And if you're the state of Texas, you should be able to get your gold.”¹⁰⁹ (He had a second point to make but forgot it.) CNBC, of course, accused Texans of “hoarding”, an odd pejorative term given that gold is stored in vaults.

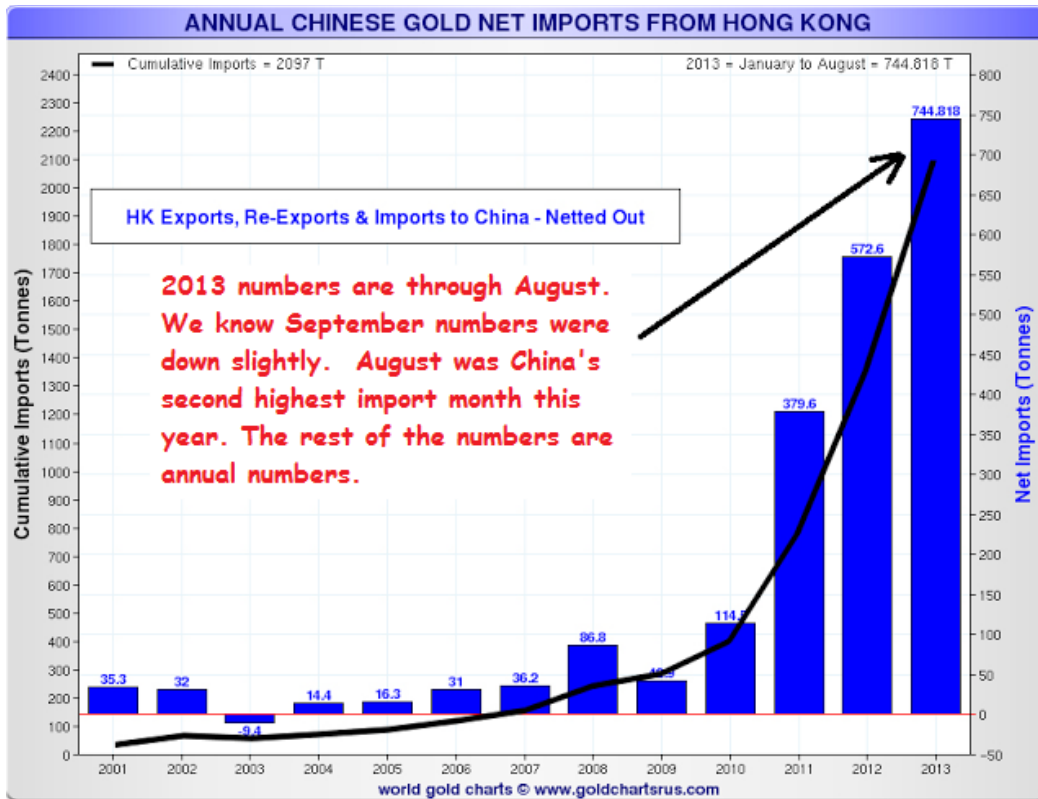


Figure 18. China gold purchases

The gold is migrating from West to East. The West is busy selling paper *and* physical gold. The East only wants the real McCoy. I suspect we are witnessing the very beginning of a fundamental change in the global currency regime, and the sovereign state currently holding the world's reserve—that would be the U.S. of A—may be in trouble. Are you sure U.S. authorities care? Take the time to read a declassified Volcker memo from 1974 describing how much the U.S. desperately wanted to demonetize gold.¹¹⁰

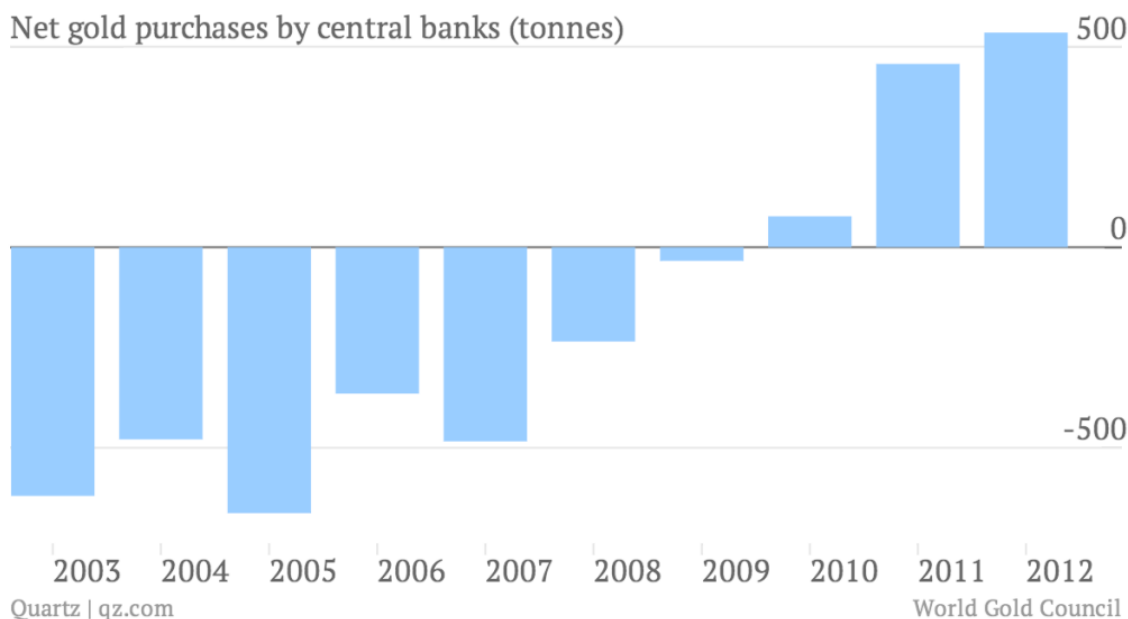


Figure 19. Central bank gold purchases

The debate continues about who actually has gold and whose gold has been rehypothecated (sold or leased out with no chance of getting it back). Some don't seem to care as evidenced by this moment of clarity:

"[Gold] can be sold, leased out, used as collateral, employed to extinguish liabilities and counted as bank capital just the same whether it exists or not."

~John Carney, CNBC

Stay with that teleprompter, John. It's your safe place. Also, take your meds. CNBC gets a special place in this review (vide infra).

Is gold manipulated now? Some very thoughtful market watchers think so whereas others do not. It certainly was manipulated back in 1974. Bloomberg recently suggested the daily London Gold Fix is, well, ripe for fixing.¹¹¹ If 2013 taught us anything it was that wealthy and powerful men and women conspire. Much of the evidence of the *motivation* underlying gold market manipulation has trickled into the public forum as cryptic utterances over the years.

"To encourage and facilitate the eventual demonetization of gold, our position is to keep the present gold price, maintain the present Bretton Woods agreement ban against official gold purchases at above the official price and encourage the gradual disposition of monetary gold through sales in the private market."

~Paul Volcker, 1974

“Central banks stand ready to lease gold in increasing quantities should the price rise.”

~Alan Greenspan, 1998

“We looked into the abyss if the gold price rose further. A further rise would have taken down one or several trading houses, which might have taken down all the rest in their wake. Therefore, at any price, at any cost, the central banks had to quell the gold price, manage it.”

~Sir Eddie George, Bank of England, 1999

“Suppressing the price of gold is very beneficial for the U.S. in maintaining the U.S. dollar’s role as the international reserve currency.”

~China’s National Foreign Exchanges Administration, 2013

We may be witnessing a monumental move on the global chessboard. Did China promise to keep buying our treasuries (against all logic) if we promised to drive gold into their coffers at high volume and steep discount? Other buyers may simply have realized that the Federal Reserve is staffed by a gaggle of boobs who think that printing gobs of money has no downside because of American exceptionalism. Figure 20 shows a frequently posted graphic illustrating the duration of reserve currencies. I suspect the next one will be gold-backed and may emerge sooner than many realize. This year has flushed the traders out of the market. I remain very long gold with very white knuckles.

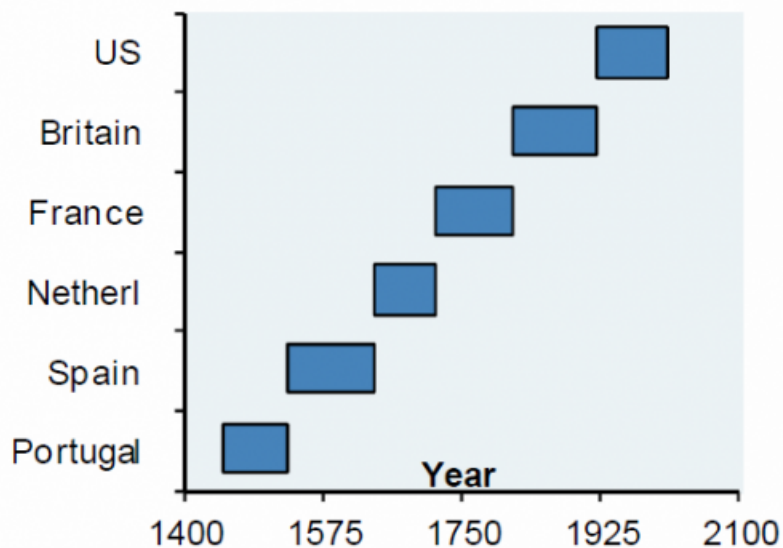


Figure 20. Reserve currencies.

Although many seem dazed and confused about the importance of gold...

“Nobody really understands gold prices, and I don’t pretend to understand them either.”

~Ben Bernanke, chair of the FOMC, 2013

“I don’t think anybody has a very good model for what makes gold prices go up or down.”

~Janet Yellen, chair-elect of the FOMC, 2014

Others see reasons to be long the shiny coins and ingots...

“I never thought it wise to sell [gold], because for Central Banks this is a reserve of safety...it gives you good protection against fluctuations of the USD.”

~Mario Draghi, President of the European Central Bank, 2013

“The Fed Will Destroy the World...we repeat our key forecasts of the S&P Composite to bottom around 450, accompanied by sub-1% U.S. 10y yields and gold above \$10,000.”

~Albert Edwards, Societe Generale

“The Fed...has embraced this dual mandate in a very harmful way...the sovereigns are under owned in gold.”

~Paul Singer, Elliot Capital

I’ve totally ignored silver in this review having said so much about it in the past.² I am still wildly bullish long term, but it is currently mirroring gold. Above-ground gold and silver bullion stashes are near parity (1–2 billion ounces) and silver is consumed voraciously by the digital world—the consumption clock is ticking. A case can be made that silver will someday decouple from gold to the upside in a substantial way.

Debt and Retirement

Savings—deferred consumption

Debt—consumption from the future pulled to the present or past

Austerity is not a policy; it is a consequence of bad policy. These definitions of saving and debt keep you from getting tangled up in dollars and cents. If you pull consumption forward, you’ll eventually have to go without later. A baby born

with absolutely nothing to its name is better off than 25% of adult Americans who are in net debt.¹¹² That holds steady until young adulthood when student debt gets a grip on many. (Student debt gets its own section owing to its complexity and importance.) The U.S. and arguably the rest of the developed world are in a boatload of trouble owing to what many call a debt supercycle—a global debt problem of monumental proportions. Can you really have a global debt problem? Yes. *To the extent that you can neither stockpile goods and services, the entire world is on the pay-as-you-go (paygo) system.* I don't care who has what drawer full of chits claiming somebody owes them money, a global demographic problem is a global debt problem.

I have described a global debt problem as the misalignment of perception and reality and still find this approach most compelling.¹¹³ If everybody thinks they will live at a level that is above the production capacity, you have a global debt problem. In dollar currency terms, if you are aware of what has been promised to you yet unaware of what your costs will be to service promises to others, you have a debt problem. Everybody knows what's in their pension, but does the average taxpayer realize that they owe \$30,000 each to top off existing municipal pension funds? Does the average taxpayer realize that their share of the total unfunded liabilities is \$2 million? *They have a debt problem.* If you are owed goods and services by folks who haven't a clue how they will pay up—a form of counterparty risk—their debt problem is now your debt problem. We can't live the American dream if we can't crank out adequate goods and services to do so.

“America's debt challenge is not a political problem. It's an arithmetic problem.”

~Simon Black, Sovereign Man blog

Let's look at some specifics. I blur the lines between debt and lack of savings on the logic that both involve misaligned expectations and reality. I talked about the Five Percentile Guy last year: \$154K annual salary with \$1.2 million of accrued wealth who is also likely to be a boomer.¹ According to the time-tested rule of 4% withdrawal in retirement to minimize risk of running out,¹⁴ this guy can pull out only \$45K per year. A more recent estimate by Roach puts this guy's *financial* assets at only \$550K.¹⁵ There are many ways to suffer at this income level, even supplemented by Social Security. Recent studies have noted that financial repression inflicted on us by the Federal reserve dropping fixed income returns to precisely squat render 4% too aggressive.¹⁴ Even a 3% withdrawal rate is said to leave a 30% chance of running out of money before you take your last breath (which should come within about a month after running out of food). At 3% withdrawal and Roach's estimates, Mr. Five Percentile Guy just slipped below the pay scale of the lowest paid commuter pilot (around \$20K). But it's worse than that. The putative well-off are *already* in trouble. We have increasing numbers of doctors declaring bankruptcy.¹¹⁶ As described in the truly marvelous book *The Millionaire Next Door*,¹¹⁷ doctors are the worst savers—but *bankruptcy?*

What about the average bloke? A typical worker near retirement has less than two years of replacement income saved, with median estimates of \$70K retirement savings for 55-year-olds. Using the rickety 4% rule, \$70K will spin off the princely sum of \$2,800 per year.¹¹⁸ Estimates state that 41% of 65–74 year olds actually living in their own house still have mortgages, and the median balance within that group is \$97,000 for pre-retirees and \$70,000 for retirees.¹¹⁹ Moody's says that a bunch of home equity lines of credit are about to reset to higher rates.¹²⁰ How many retirees will be caught by that? More than 30% of 45–55 year olds have saved nothing for retirement.¹²¹ The median retirement account across all age brackets is estimated at \$3000.¹²² The boomers aren't such an aberration.

Any notion we will grow our way out of this problem is suspect in light of median wages, which have shrunk in the last five years¹²³ and are said to have largely stagnated (inflation-adjusted) for production workers for several decades.¹²⁴ Sixty percent of workers accumulated more debt than they contributed to retirement savings between 2010 and 2011. One fifth of 401K holders have a loan against it.¹²⁵ Frontline's "The Retirement Gamble" is worth a peek.¹²⁶ Ted Benna, the father of the 401K, is horrified at his creation.¹²⁷

This is a sad state of affairs. It seems unlikely that the spiking price of Netflix or a Twitter IPO will save us. *Austerity is not a policy.*

Three random bits of advice to the young:

- (1) Save more and spend less. You will have more and need less.
- (2) Stop buying cigarettes and lotto tickets at the convenience store.
- (3) Read *Millionaire Next Door* in your early 20s.

One of my employees from China has been in the U.S. for a dozen years and just became a naturalized U.S. citizen. I know what she is paid. Her husband maintains an independent apartment working in Chicago. She has paid off a huge percentage of her house, maxed out her retirement account, and put a son through Cornell without taking on a penny of debt. She shames us all.

Municipal Debt

"I refuse to let Detroit go bankrupt."

~Barack Obama, 2012

Of course, the big news in the municipal bond market (munis) was the Chapter 9 filing by Detroit.¹²⁸ After years of a non-revitalizing economy, the entire city simply fell into its own foundation. Videos with various "Detroit Ghetto" titles are a must see.¹²⁹ (Watch the boats: they represent a bygone era of hopes and dreams.) I find one photo montage capturing Detroit's previous splendor in total ruin to be particularly disturbing.¹³⁰ A judge tried to stop the bankruptcy,¹³¹ but no judicial fiat can change reality: they are out of cash and \$20 billion in the hole. (Ironically, the presiding judge is an expert on Ponzi schemes.¹³²) A Michigan

bond deal went fully unsubscribed;¹³³ you've got to imagine Detroit played a role in that.

I'm not sure Detroit's plight was inevitable, but it was to be an uphill battle at best. The pension costs get a lot of credit, but they are only 5% of the budget.¹³⁴ The fees paid to the financial system on the general obligation bonds used to top off the pensions, however, may have been oppressive.¹³⁵ Some suggest that Detroit failed to adjust in real time, causing them to hit the bridge abutment at full throttle. Failure to curb waste and make mid-course corrections in *any* economy is bad (and it's happening everywhere.) So what is Detroit planning as all seems lost? A toga party? No. Building a taxpayer-funded sports arena!¹³⁶ (The economics of such projects have been discredited by multiple analyses.¹³⁷) As a non-fan of government-sponsored programs, I would enthusiastically support Federal funds to pay local blue-collar workers to bulldoze dozens of square miles of abandoned buildings. I could imagine green sprouts emerging over time, but not from total wreckage.

The day that Beirut on the Lake went belly up the Dow hit all-time highs. The muni bond market, by contrast, got the bejeesus scared out of it with good cause.¹³⁸ Illinois, for example, seems to have some serious problems with a pension fund that is only 40% funded—\$53 billion in the hole and still digging.¹³⁹ An Illinois public relations man fought back against Zero Hedge's assertion that the pension is in big trouble. That was Baghdad Bob talking because their pension guru said that the "Illinois Teachers Retirement System cannot invest its way out of the funding hole we are in." Illinois had a debt sale that went south and was promptly delayed, prompting Cate Long, a prolific writer on municipal debt, to note wryly that "something went very wrong." Cook County is \$140 million in the hole. Is that big? I don't know. The state is \$305 billion in the hole—\$30,000 per taxpayer. *That's* big. Meanwhile, 1 in 6 Illinoisans are on food stamps.¹⁴⁰

Other states are not far behind. Only eight states have budget surpluses.¹⁴¹ California has state and local governments that are in the hole for over \$1 trillion—\$26,000 per *capita*.¹⁴² CalPERS is having trouble collecting pension payments from the municipalities.¹⁴³ It's not surprising given bankruptcies in Vallejo, San Bernardino, Mammoth Lakes, Stockton (probably "just to name a few").¹⁴⁴ The overall muni market showed serious stress by June of this year. Puerto Rico's problems led to a 20% bond collapse in a single month,¹⁴⁵ posing the question of how far our concerns should reach. Given that QE has been bailing out all of Europe, it seems that question has been answered.

Many of the wounds were self-inflicted with Wall Street supplying the weapon. A number of states are suffering because they sold bonds against their revenues from the tobacco settlement, only to watch the tobacco revenues tail off with abstinence.¹⁴⁶ Stockton was guided into bankruptcy by some ill-conceived pension obligation bonds that went bad. Jefferson County won billions in a settlement (although certainly not enough) related to scams against it.¹⁴⁷ Denver is spending over 60% of its school budget to unwind ill-advised derivatives trades.¹⁴⁸ Miami-Dade County's \$91 million loan to build the Marlins a new

stadium (another stadium!) cost them an additional \$1.2 billion in fees.¹⁴⁹ Maybe some of the Marlins players can IPO themselves to help pick up the tab. Watch out for forthcoming privatizations Chicago style.¹⁵⁰ It all makes you wonder whether some of the mayors are smoking crack.

“Yes, I have smoked crack cocaine, probably in one of my drunken stupors.”

~ Rob Ford, mayor of Toronto

Student Debt

“The subprime mess is grave but largely contained”

~Ben Bernanke, 2007

“The amount of U.S. student debt is large, but not particularly likely to cause macro-economic instability.”

~Ben Bernanke, 2013

The student debt problem is often presented in simple terms: unlimited credit allows banks to saddle mentally impaired consumers (18-year-olds) with non-dischargeable loans at usurious rates to pay soaring tuition bills stemming from gold-plated amenities and overpaid faculty, all of which have come about because colleges can charge anything they want. There are shards of truth in there, but the story is a little more nuanced. Let’s first look at the problem, which is undeniable.

Student debt has soared to over \$1 trillion, causing many to declare it the next bubble (Figure 21). Last year I argued that stringent legal protections by even the most usurious lenders would preclude the popping phase. Apparently, the students did not read my review: the bubble is popping (Figure 22). Seven million student loans are in default;¹⁵¹ 50% of all loans are in forbearance or deferment.¹⁵² You cannot squeeze blood out of a stone. Parents who had the stones to cosign are another story.

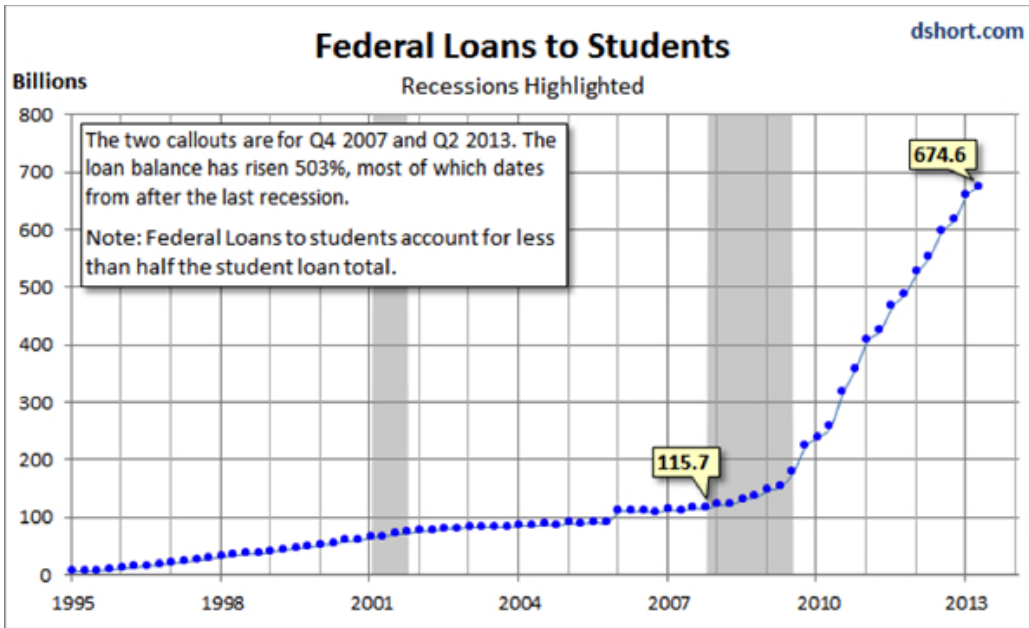


Figure 21. Growth in student debt.

Student debt that at one time appeared to be a highly protected asset class is increasingly becoming subprime and defaulting.¹⁵³ Sallie Mae was forced to cancel debt offerings.¹⁵⁴ The popular Stafford loans are about to see their interest rates double (3.4% to 6.8%).¹⁵⁵ That's really gonna smart. I'm unsure how this is going to play out. Right now it's simply a monumental mess.

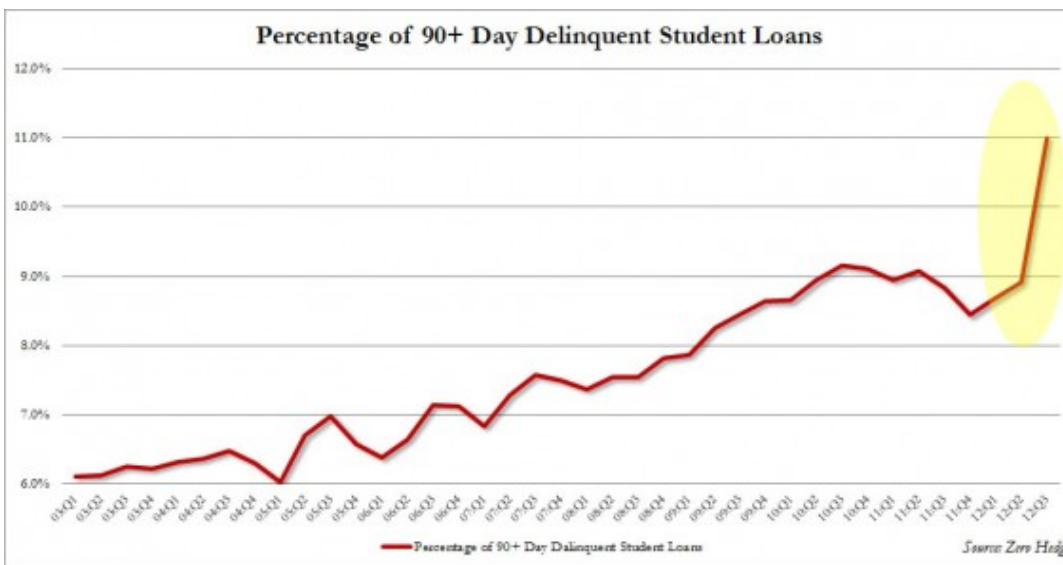


Figure 22. Delinquent student loans.

What really concerns me is that student debt is almost guaranteed to hobble a generation and our economy for years. I obsess over the diversion of what Bloomberg called "indentured students" who had the potential to change the

world but, instead, will be forced to plant themselves in a cubical to get three square meals, a roof, and a monthly loan payment. Generation Hosed is justifiably irritated. Imagine watching brokerage ads touting ages 25–35 as critically formative saving years while sitting on a huge pile of student debt accruing penalties *and* sitting on your parents' couch doubling as a bed. They were told to get a degree and a job. One out of two *is* bad.

“For those of you who may be unaware, [Michael] Boskin is the economist / weasel / fraud who helped to officially distort the CPI, making it more or less worthless as a measure of inflation. The Boskin Commission... was an act of cowardice. Rather than man up and say 'fix this, its broken, we can't afford it...'"

~Barry Ritholtz

“You can't trust those American GDP numbers. They cook the books”

~Chinese Finance Ministry

Are college costs really soaring above inflation and, if so why? The charts say they are (Figure 23). Although offering little consolation, I suggested in last year's review that tuition—the cost of running a small city—may be a better measure of the true inflation rate than is the politicized CPI. Figure 24 shows a CPI that is clearly too low to anybody who remembers prices in 1978. I lived in NYC on a \$4400 annual stipend in 1978 and could get a full breakfast for under a dollar. The inflation measures coming out of ShadowStats.com and tuition hikes aren't *that* far off. Nonetheless, the affordability of college is undeniably declining. As a case in point, costs to go to the University of Wisconsin have soared relative to 40 years ago when measured by hours needed to work your way through—summer plus 50 hours per week now versus summer plus 10 hours per week 40 then.¹⁵⁶ Embedded in this benchmark, however, is the failure of low-paying jobs to keep up with the real costs of living.

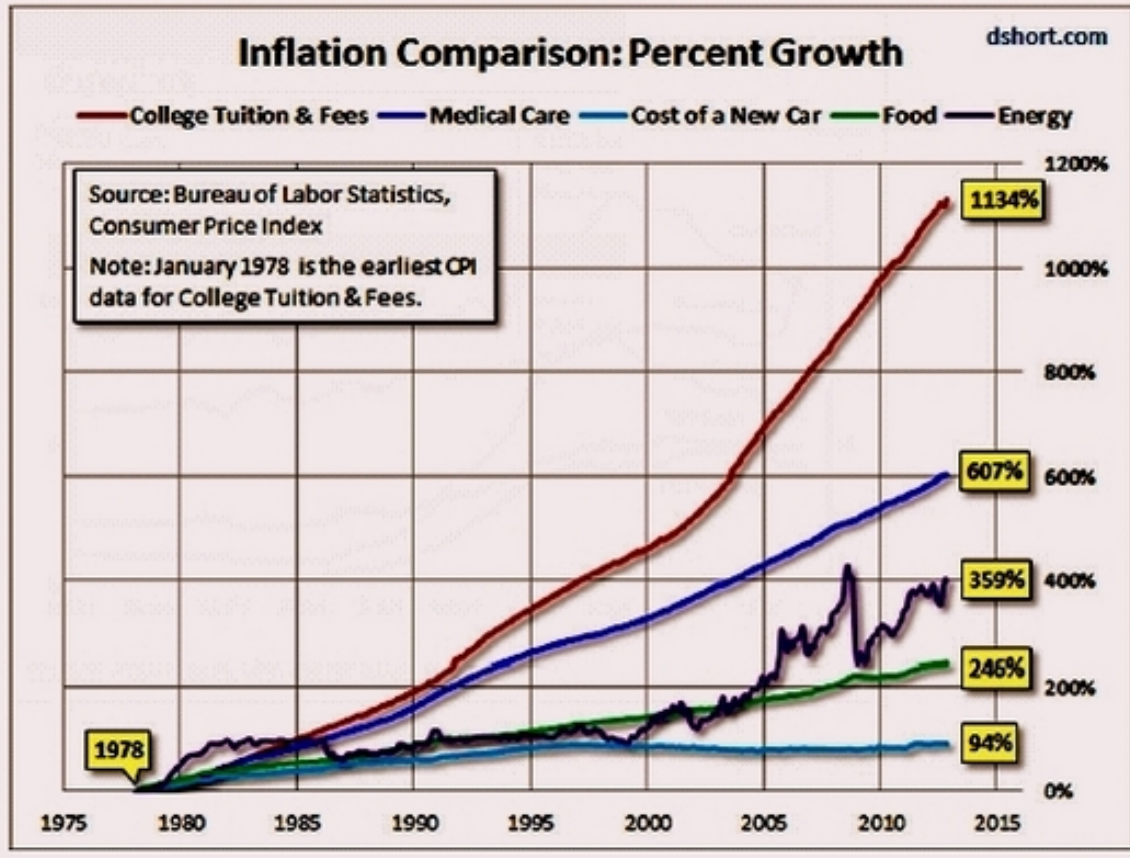


Figure 23. College tuition versus medical costs and the cost of living (CPI).



Figure 24. Inflation according to the CPI (red) and ShadowStats.com (blue).

I concede that tuition is rising above inflation, but where is the hemorrhage? When I arrived at Cornell in 1980 *everything* that had direct comparison with the present was supported at a higher level. The staffing levels—a huge percentage

of the cost—were higher. The number of teaching assistants was larger. I have spoken with many in the university community, including 3 hours with colleague Ron Ehrenberg, an economist with a globally recognized expertise on university finance.¹⁵⁷ There is no simple answer. I imagined that in a winner-take-all system, that the highest-paid faculty had elongated the pay scale. I can't speak for the nation at large, but this is definitely *not* true in my department. Comparing salaries of the top three faculty with those of starting assistant professors reveals a proportionality that has not budged since 1980. Moreover, faculty salaries have slipped when compared with graduate student stipends.

I suspect—*suspect*—that the bloat has appeared in middle management and administrative staff. What is difficult to fathom by those outside the system, however, is the enormous complexity of running an institution that is tied in every respect to state and federal government. Compliance with financial and social responsibilities has grown, a form of unfunded mandates. Think about the changes that have occurred in the typical doctor's office; that has happened at universities as well. I suspect universities could do better, but it is a battle.

How about the luxurious facilities? Indeed, they are constantly improving relative to the olden days. There is an arms race to get the best students. But our buildings and dorms are largely funded from private donations and government sources, not tuition. Recent construction at Cornell has been paid for by Seth Klarman, Sandy Weill, and Bill and Melinda Gates. Chuck Feeney (Duty-Free Shops fame) has donated almost \$1 billion to Cornell, including the money to build the new dorms that supposedly drive up the cost of housing. Money flooding in from wealthy alumni goes to *mitigate* the costs of education. The real cost of running a university is *much* higher than the tuition dollars collected.

I do not have solutions to the existing problem, but I do have a few suggestions.

- (1) Don't go to an expensive college when a cheap one will suffice. Some of the state schools are spectacular, although they are getting more expensive.
- (2) Help your kids think about their majors; some subjects should be minors.
- (3) Start cheaply and transfer into the elite schools.
- (4) Some kids should delay entering college or take time off after entering school to sharpen their focus. (Parents are often the biggest obstacles to such a plan.)
- (5) Skip college if you are just going to screw around; it is an expensive way to learn keg-stand skills.
- (6) We should develop payment systems based on percentage of income for a set number of years after graduation to protect students from impossible payment schemes and incentivize schools to produce a profitable education.
- (7) Don't count on the massive open online courses—the MOOCs—to save us. I've gotten to know 18- to 22-year-olds pretty well, and the maturity required to excel without the cloistering of the campus life is rare. MOOCs could be part of the solution, but only part.
- (8) Wealthy donors might consider supporting renovations of existing structures rather than new buildings. It's a much harder sell for administrators.

Everybody says we need more college graduates. That's a total crock. We need a more skilled populace. For some, education provides the needed skills. Others should find the skills elsewhere.

Bonds and Sovereign Debt

"No, Mr. Bond, I expect you to die."

~Goldfinger

Bonds and, by proxy, sovereign debt almost became the story of the year when the Fed threatened to taper QE. Interest rates rose sharply, and the Fed went completely spineless and did an Emily Litella "never mind." This year foreshadowed what might happen when bonds finally sell off in earnest.

But if this is the one bubble that rules them all—and I believe it is—this bubble is a very strange one indeed because it is feared by all. Foreigners are selling bonds. Brokerages are hiding from them, issuing warnings to their customers to lighten up or at least shorten up the duration (to about 15 minutes.) The reach for yield is going other places. In February UBS warned its clients to lighten up¹⁵⁸ with the same urgency that Jamie Dimon told the DOJ to lighten up. Bank of America (BofA) warned of a bond crash.¹⁵⁹ HSBC warned of the "great liquidity drought."¹⁶⁰ Mohamed El Erian of Pimco asked rhetorically, "why is it that the Pimcos of this world are not disciplining a system that is becoming more and more artificial? Why do we allow the manipulation?"

Are we *sure* it's a bubble? *Yes, it is a bubble.* Rwanda's 10-year debt dropped below 6%.¹⁶¹ *Rwanda?* The U.S. junk bond market has hit a record \$2 trillion.¹⁶² Barclays says that "the U.S. high yield index fell to a record-low 4.97%, the first time it has ever fallen below 5%."¹⁶³

Apple, with its enormous cash balance—a *real* cash balance in excess of \$100 billion—sold 30-year debt, turning itself into combination tech company and levered hedge fund.¹⁶⁴ Let me wrap my brain around this: a *tech* company selling 30-year debt? Tech companies should avoid buying green bananas for their cafeteria. Oddly enough, Apple's share price almost immediately started its downward slide, and the Apple bonds are already underwater, losing 9% of their principal in one week.¹⁶⁵

So yes, it's a bubble. Just look at the chart (Figure 25). Rates were this low in the post-WWII disinflationary period in which the U.S. was the *only* financial juggernaut in the world. That is no longer the case.



Figure 25. Interest rates on 10-year treasury, 1967–present.

The irony is that the low yields (high prices) are manifestations of inflation incited by the Feds (or what a Rabobank analyst called “The Great Flotation”.) The central banks can keep it up for awhile—maybe even a long while—but the day will come when the Fed will be forced to taper. What if they don’t taper? Doesn’t matter. Someday the bond market will roll over with a gigantic groan because this gigantic chunk of debt illustrated in Figure 26 *normalized to GDP* is top heavy. (The downturn in Figure 26 is largely mortgage defaults; the real deleveraging has not begun.) We will then discover that bonds have risk. Jim Rogers noted that a 1% rise on the 10-year bond shaves 9% off the principal. Jim Rickards is predicting that rising rates will cut bond portfolios in half. The 1987 crash was preceded by rising rates that went unheeded by risk seekers; equity investors are likely to find the risk they are always professing to seek. (See The Bear Case above.)

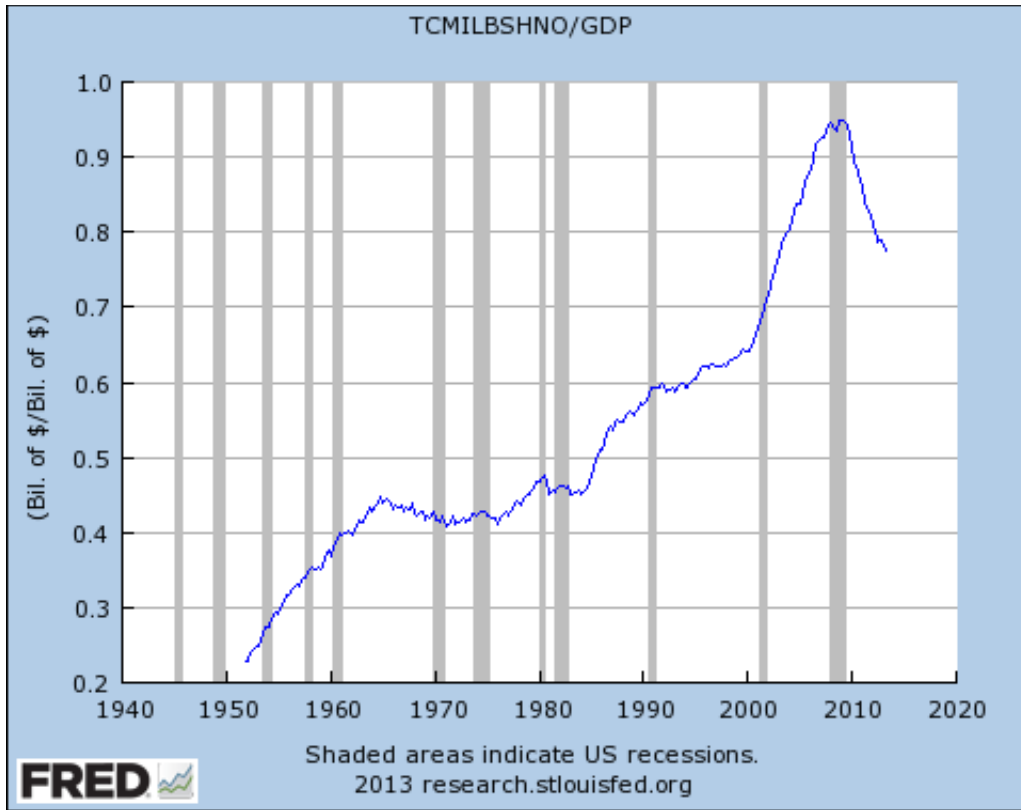


Figure 26. Debt normalized to GDP.

Low interest rates have been supporting marginally profitable enterprises. I've already noted that corporate profit margins supported by low borrowing costs are at record highs; they will regress to the mean and p/e ratios will follow. Many marginal enterprises will become unprofitable. We will have the epiphany to end all epiphanies: The Fed doesn't have a clue what it's doing. It will get a lesson in malinvestment. The bubble may not burst instantaneously—maybe it will be in slow motion—but it will leave investors prostrate before the secular bear market is over. And it won't be our children and grandchildren who pay—that meme trivializes the risk because we obviously don't give a hoot about them. It will be *us*, and it will be a generational lesson.

But this year, we got only a belch from Vesuvius. The peasants of Pompei have returned to their homes confident that the Gods contained the risk.

"There were some so afraid of death that they prayed for death."

~Pliny the Younger, on the eruption of Vesuvius

Housing and the Mortgage Markets

“The last time the housing market was this hot in Phoenix and Las Vegas, the buyers pushing up prices were mostly small time. Nowadays, they are big time — Wall Street big.”

~*New York Times*

You would be forgiven if you were confused by the housing markets. We are being told by waves of pundits that housing is in full recovery mode. How could this be? Didn't we just build more houses than the system could possibly absorb? Didn't Greenspan convince homeowners to withdraw equity from their houses, only to find out that they lived in the same house but owed twice as much? Are we generating yet another bubble? Yes and no. We have a huge credit bubble but not a new housing bubble, only the aftermath of a deflating old one. Figure 27 shows new housing starts, and the double-digit percentage growth in new housing starts said to be the “largest surge in home sales since 1980” is feeble at best. Can't see it at the far right edge of Figure 27? Maybe zooming in or squinting will help. A trillion dollars per year of Fed stimulus bought us *that*?



Figure 27. Single family housing starts 1964–present.

There are indeed new buyers coming into the market, but many would-be new buyers are unemployed 20-somethings living in the basements of their parents houses—houses that have a 22% probability of being funded by an underwater mortgage.¹⁶⁶ An estimated 11 million mortgages are underwater.

The plot thickens when you find that up to 60% of new buyers of single family homes (SFHs) are paying with cash.¹⁶⁷ We really *are* rich! Well, not exactly. This wave of buyers are private equity firms, hedge funds, and big banks leveraging up using Fed largesse to buy billions of dollars worth of SFHs. *It's not cash.* They are securitizing the houses to market rent-backed bonds and rental REITs (real estate investment trusts).¹⁶⁸ Maybe these are the first buyers—the vanguard—who appear at the bottom in any distressed market. I also believe that some renters, formerly unsuited homeowners, should remain renters. So maybe all is going according to plan.

Here's where the plotline turns dark. SFH rentals are notoriously lousy businesses. Ask any homeowner. There are already reports of renters being unable to get in touch with the absentee landlords.¹⁶⁹ Wall Street often places huge bets on lousy businesses; they are the new flippers. Recent entrants include

JPM, Deutsche Bank, and Blackstone. New companies with catchy names like American Homes 4 Rent are announcing IPOs. You'll be seeing a lot of post-IPO charts like that of Silver Bay Realty Trust Corp (SBY; Figure 28) and American Residential Properties (ARPI). Goldman traders supposedly referred to these two companies as "straight to Muppet dump."¹⁷⁰ It will be much like the mortgage craze of a decade ago except the appreciation part—the honeymoon period for investors—will be *very* short-lived. Shiller thinks this is a new mania in which the Wall Street is just chasing momentum, but what does he know?¹⁷¹ Regardless, a new wave of securities are coming to a pension fund near you. Cover your faces because they are about to get ripped off.



Figure 28. Silver Bay Royalty Trust Corp (SBY; rental REIT)

Europe

“Europe should let go of hopeless causes”

~*Financial Times*

That, unfortunately, would be Europe. Europe has been tribal for millennia. It is the exceptional moment when a bar fight isn't breaking out somewhere on the continent. Fighting stops when they run out of resources. Many factors for European conflict are squarely in place. Leader of the UK Independent Party, Nigel Farage, is betting on “violent revolution across Europe.” I'm sure others share his view if not his penchant for unmitigated prose. The U.S. has been attempting to hold Europe together. Unbeknownst to many, the top five recipients of QE II went to European banks.¹⁷² Really? Not the guys at the local VFW? Even with that help, the European banks have a boatload of bad loans.

Europe's debt-to-GDP ratio is soaring while building permits are dropping to zero.¹⁷³ The European Union is a loosely affiliated group of basket cases. It is painfully instructive to look at them basket by basket.

"We are continuing to see the EU crumbling before our eyes."

~Benn Steil, Council on Foreign Relations

Greece. Put a fork in it. Unemployment exceeds 25%, and youth unemployment exceeds 50%.¹⁷⁴ Recall that violent behavior usually comes from unemployed youth; they are incapable of waxing philosophically like their ancestors. Several large Greek banks have collapsed, and there weren't that many to start with. Branches are closing at the rate of two or three per day.¹⁷⁵ Authorities placed restrictions on withdrawals to stem the flow of capital. Indeed, it worked. Hardly a euro will ever flow into the Greek banking system—Hotel California in reverse. The IMF is said to have manhandled Greece, turning their economy into a pile of rubble owing to their austerity policy. *Austerity is not a policy; it is a consequence of bad policy.* Nobody should ever lend to the Greeks; they are the perennial world default champions. Greece continues to create ruins.

Spain. Good news. Spanish debt is registering some pretty low interest rates. The bad news is that those rates reflect a monumental global credit bubble fueled by monetary interventionists of a higher order. Spain has over a trillion dollars of debt and has been through a half dozen bailouts in short order.¹⁷⁶ Debt service is sucking up 30% of its tax revenues. Spain was forced to "borrow" from its social security reserve to fund pension payments.¹⁷⁷ New Jersey did this too,¹⁷⁸ which puts Spain in bad company. Spain also has a monstrous property bubble with over 800,000 unfilled homes.¹⁷⁹ Rumors of a 47-story office building in which the contractors had forgotten to install elevators¹⁸⁰ is probably a spoof turned internet legend, but how would you know? One intrepid Canadian debt analyst asked, "Do I really want to blow my brains out in Spain again?"¹⁸¹ I'm guessing he's not loading up on Spanish debt in his personal account. Heads up: Once Spain's creditors have retrieved as much as possible from bailouts, they will be replaced with bail-ins. Film at 11:00.

France. S&P just downgraded France's debt, so the French are looking a little fried. The French finance minister Michel Sapin said that "there is a state but it is a totally bankrupt state," and he goes on to note that "a flight of capital has already left the country amid concerns that France's Socialist leader intends to soak the rich and businesses." The president of France, Francois Hollande has things under control: "We can't let the Euro fluctuate as the market sees fit". Socialism is likely to live up to expectations. France also happens to have the second biggest pension deficit—a colossal one at that.¹⁸²

"We all know what to do; we just don't know how to get reelected after we've done it."

~Jean-Claude Juncker, prime minister of Luxemborg

Germany. Well, at least there's Germany. They must be doing well, right? First off, I would not be the first casual observer of history to notice certain geopolitical trends that keep appearing when Germany gets strong. More to the point, however, Germany has its problems. The DAX has rocked, doubling in only four years, while economic growth dropped from 4% to 0.7% over this same period.¹⁸³ Trend-following hedge funds don't care, but the rest of us probably should. Germany also has the largest pension deficit in all of Europe. Their pensions are less funded than Detroit'. Reunification came at a cost.¹⁸

The Rest. Sweden had four days of riots. Riots in *Sweden*? Ireland held the G8 meeting and created fake store fronts—a Potemkin Village—for the visitors. A governor of the Bank of England suggested that “there is momentum behind the recovery that's coming” (like the momentum the car in my garage has).¹⁸⁴ Britain has a huge housing bubble.¹⁸⁵ Portugal is broke, unemployed, Spain's Mini Me. I can't keep this up...(projectile vomit)...(burp). This is nauseating; let's move on.

What? No Cyprus? Cyprus is more than just a country imploding. Cyprus is a beta test for some very bad things and gets its very own basket.

Cyprus

“There is really no more stupid an idea even to consider a suggestion for a haircut on bank deposits”

~Michael Sarris, finance minister of Cyprus

Cyprus may eventually become part of a huge story. Cyprus's banking system passed the sham we call bank stress tests and was subsequently found to be insolvent, in no small part owing to pressure on Cypriot banks to buy Greek debt to bail out the Greeks.¹⁸⁶ Enter the “bail-in”, a euphemism that describes a bailout of a bank using taxpayers deposits to avoid burdening taxpayers.¹⁸⁷ (Huh?) The haircut to depositors throughout the island kingdom was said to be 10%, a decimation in the purest sense. It might also be referred to as an “eisphora”, an emergency tax invented in fifth century BC Greece. The banking system was in complete lockdown. Emergency parliamentary sessions were scheduled and cancelled. The peasants were unhappy. This was bewildering for the head of the central bank named Panicos. No nickname needed there.

Substantial penalty for late withdrawals

~Sign in Cyprus bank window

Soon stories began to leak out that the master plan was to clip \$60 billion from Russian oligarchs using the shady Cypriot banking system for nefarious purposes.¹⁸⁸ (The Cypriot banking system is actually quite transparent—literally so now that the banks have been vacated, leaving “see-through” buildings.) We discovered, however, that the Russian oligarchs had gotten wind of the bail-in

the previous week and emptied their accounts.¹⁸⁹ Those that did not were able to do so at their leisure through the London offices of Cypriot banks, which were conveniently kept open.¹⁹⁰ The president of Cyprus and his friends also exited; can you blame them?¹⁹¹ Soon the reported bail-in rose to 20%, 50%, and then urban legend levels of 90%.¹⁹² *That* is an expensive and indiscriminate haircut, especially for depositors in some banks that were not insolvent. The details probably don't matter to non-Cypriots. Once the dust settled, Cyprus imposed capital controls to stem the flow out of the country by "slamming the bank door."

"We cannot serve you right now due to upgrade."

~Quote from Cyprus ATM

Why would Cypriot politicians let the country get looted? Well, politicians are fungible, and the going price for any politician never exceeds six digits, whereas the looting was on an 11-digit scale. Probes into the carnage began but then terminated owing to "insufficient data".¹⁹³

Rest of the World

"Only Europe and the U.S. can stop the world from falling apart."

~Wolfgang Schäuble, German finance minister

What you mean US Kemosabe? Asia is clearly of profound importance going forward. I can imagine writing volumes in some future Year in Review, but it feels like Asia is in a holding pattern with troubles in the queue waiting to make headlines. A China/Japan or North Korea/South Korea military conflict could bring on the fireworks. The Fukushima nuke story continues to smolder.

China watchers I respect are both wildly bullish (Stephen Roach) and wildly bearish (Jim Chanos). I suspect both bulls and bears are right at some level. Credit and real estate bubbles (ghost cities) suggest China portend a crisis, and the authorities are terrified of the response by the citizenry. If you recognized the China growth story 15 years ago and dumped your money into the Fidelity China Region fund—I did at one point, but only briefly—you would have beat the S&P, but your annual compounded return would have only been 5%. This is disappointing for a miraculous growth story, especially if the downside risk is large. A hoard of investors are focusing specifically on Mongolia, but their economy is in its infancy (baby steppes), and it doesn't interest me yet. I will, however, put in two cents on Japan.

"Japan appears to be turning the economic corner."

~Jack Lew, secretary of the Treasury, 2013

"Japan has turned the corner"

~Stefan Green, Goldman Sachs, 2007

“Japan has turned the corner”

~John Taylor, undersecretary of the Treasury, 2003

It's little wonder they make good cars. They will also likely be the market leader in "cluster trucks." Japan has truly massive demographic problems. As noted earlier but worthy of reiteration, estimates are that in 20 years Japan will have *one worker providing all the goods and services for four people*. Neither Abenomics nor the Yakuza are gonna change that butt-ugly picture. Kyle Bass is always giving must-see talks on Japan's mathematically impossible recovery.¹⁹ Even the major brokerages follow this plotline. It seems to have attained truism status for at least some pundits that rising interest rates in the JGBs will destroy Japan's currency, markets, and economy, and interest rates will rise someday. The BOJ, like central bankers around the globe, is determined to print around, over, or through this problem. (Am I the only one who thinks BOJ sounds pornographic?) Last time Japan tried to inflate its way out of debt was the 1930s. It led to hyperinflation, assassination of the prime minister, and World War II. The most direct solution to demography was provided by Japanese finance minister Taro Aso who suggested that the elderly should “hurry up and die” rather than drain the resources of the government.¹⁹⁴ They had better hurry up, because the Japanese government is currently borrowing half of its federal budget every year.

My dark horse winner for the 21st century is Russia: they have land and resources. All they have to do is straighten out their political system. Moscow is said to have the largest number of billionaires of any city in the world, but every one of them stole their wealth, which suggests finance and banking will be growth industries.

I have little to say about or interest in South America. Brazil is the lead off batter for the BRICs but recently started fanning strikes.¹⁹⁵ Argentina, once viewed as the Western Hemisphere's rising superpower, is now what Henry Kissinger referred to as a “dagger aimed at the heart of Antarctica.”

And then there's Africa. I hear rumblings that Sub-Saharan Africa is a future growth region. This is garbage analysis. Read Hernando DeSoto's *The Mystery of Capital*.¹⁹⁶ Africa has no ports, no inland waterways, no property laws, weak educational systems, more AIDS than any region of the World, a large machete-toting populace, and numerous oppressive dictators. Although one of my very bright colleagues is actually creating a bank in Ghana, I don't think any quantity of Bill Gates' help will dent Africa's problems. I will not be investing in a Fidelity Africa Fund anytime soon.

Confiscation

“This could go down as a blunder of historic proportions.”

Cyprus could slide into grinding abject poverty without anybody really noticing, but that is only part of the story. Confiscation of bank deposits was declared illegal and unreasoned by squeals across the blogosphere and globe. The reality might be a little more nuanced and a little scarier. A number of countries have mechanisms for confiscation embedded deeply in their legal system, including the United States.¹⁹⁷ *Come again?* Poland overtly nationalized private pension funds.¹⁹⁸ Spain implemented a “clunkers for cash” program by converting 97% of the social security pensions to Spanish government debt, up from 50% in 2008. Russia nationalized its pension funds.¹⁹⁹ Both the IMF proposed a 10% tax across the Eurozone,²⁰⁰ and the BIS proposes bail-ins internationally *including the U.S.*²⁰¹ Ouch. France’s President Hollande wishes to remove the inflation adjustment from the country’s pension fund.²⁰² Next up? Inflation of course.

People in positions of power seem enamored with the bail-in (confiscation) model to correct imbalances. A student of history would *not* find this surprising. According to Matt King of Citigroup, “the very success of the [Cyprus] solution now being adopted seems likely to lead to its replication elsewhere.”²⁰³ The Troika set their sights on Luxembourg, possibly for another beta test.²⁰⁴ Eurogroup head, Jeroen Dijsselbloem (pronounced “Diesel....BOOM!”) suggested that “a rescue program agreed for Cyprus...represents a new template for resolving euro zone banking problems, and other countries may have to restructure their banking sectors.”²⁰⁵ EU economic affairs chief Olli Rehn enthusiastically endorsed the bail-in model while assuring Europeans that “the limit of 100,000 euros is sacred; deposits smaller than that are always safe.”²⁰⁶ Very soothing words indeed.

JPM warns of capital controls across Europe. I suspect that an ongoing stealth bank run is afoot in Europe. Would you keep your money in Luxembourg, Portugal, Spain, Italy, or Greece? I didn’t think so. Dmitry Medvedev caught many people’s sentiments with the cryptic but unambiguous suggestion that you should “Get all money out of western banks now!”²⁰⁷ It’s not just Europe: the Aussies are going to double-tax their Roth IRA equivalent.²⁰⁸

Let’s bring it to the U.S. and see how *we’re* doing. The risk of confiscation is showing up in some not-so-subtle ways. The U.S. Consumer Financial Protection Bureau is weighing whether it should take on a role in helping Americans manage the \$19.4 trillion they have put into retirement savings. Bureau director Richard Cordray is “interested in...what authority we have” but “didn’t provide additional details.” Little good will come of this. Beware of people from the government offering to help. Along comes Fed governor Donald Kohn declaring that a bail-in is needed to protect the system from too big to fail banks.²⁰⁹ You now have my attention, Don.

In 2006 I diversified my assets across a broader range of banks to dodge bank runs—I *did see it coming*—but that now provides much less protection. New bank

account protection changed from \$250K *per account* to \$250K *per Social Security number*.²¹⁰ Deposits in foreign branches of U.S. banks are no longer FDIC insured. We are all Cypriots now. A number of years ago the blogosphere was chattering about the role of a depositor at banks and owners of equities and mutual funds at brokerage houses. In the simplest of terms, equities are in the name of the brokerage. That turns us peasants into creditors and not very senior ones at that. (File under lessons learned from MF Global.)²¹¹

Steve Forbes warned that a Cyprus-style seizure of your money could happen here.²¹² I'll take "Holy Shit!" for \$1000, Alex. JPM has already limited cash withdrawals and wire transfers abroad for reasons that elude me now but probably will become clear later.²¹³ This move seems to be at the behest of the Federal Reserve. Apparently, only the Fed is allowed to ship unimaginable sums to other countries.

Jim Rogers certainly sees dead people: "401k plans, IRA's, and pension plans which the government knows about [may be next]...*Anything they know about they might easily take*"²¹⁴ (my emphasis). Discussions at the highest levels have already hinted at capping retirement withdrawals to a "\$205K per year annuity."²¹⁵ A little rampant inflation could bring many retirees under that umbrella (not unlike the alternative minimum tax.) The term "annuity" should also trouble potential heirs. In other incarnations, the administration proposes to "prohibit individuals from accumulating over \$3 million in tax-preferred retirement accounts."²¹⁶ (I think they meant "tax-deferred, because "tax-preferred" is a phrase of little merit.) Does that mean that they will skim anything above that? It ain't just Mitt who will take a hit. I may terminate my sheltered contributions.

"This is a major, *major* game changer...full-blown socialism, and I still can't believe it happened"

~ Lars Seier Christensen, CEO of Saxo Bank

The brutal reality is that the pension doomers (Pete Petersen, Larry Kotlikoff, and Rich Marin to name a few) know that the system is going to topple. Reality could be far worse than the threats described above, and it will play out at the local, state, and sovereign level. Cities are confiscating assets in police raids as a source of revenue.²¹⁷ The use of eminent domain to confiscate mortgage-backed securities ostensibly to help home owners is downright creepy.²¹⁸ Remember: *austerity is not a policy.*

"And now you know the rest of the story."

~Paul Harvey

The Fourth Estate

“It’s become a cliché these days to say you don’t trust the media. But you know what? You’re right not to do so. The problems aren’t as bad as they appear. They are much, much worse.”

~Brett Arends, *Wall Street Journal*

In the ultimate irony the media was in the news this year. Of course, there were the little things like Charles Payne buying stocks before touting them on Fox Business News. Chicago algo traders who were beating the speed of light in trading (see *Broken Markets*) appeared to be getting their advance info on the Fed minutes from “sequestered” prostitutes posing as reporters. My favorite mishap was this poor guy whose first day on the job at a local station didn’t go as smoothly as he’d hoped.²¹⁹ But there were some really big stories. Some, like the role of the *Guardian* in the Edward Snowden leak and battles over what defines a legitimate member of the media (hint: not bloggers), are embedded in *Civil Liberties*. Other media-centric scandals are mentioned here.

Bloomberg reporters were snooping on traders using the famous Bloomberg terminals. Traders were baffled by Bloomberg’s sleuthiness. The snooping was detected when a Bloomberg reporter asked about someone who had “not logged into his terminal in a few weeks.”²²⁰ Don’t lie to me Big Mike: Did Bloomberg reporters use a subscription service to monitor the activities at the big banks? Not exactly a Chinese wall. Ten’s of thousands of intercepted text messages give this story a shade of Rupert Murdoch.

The University of Michigan confidence numbers (MCSI), popular triggers for algos and HFTs, were being released by Reuters early; dissemination times depended on a tiered pay scale.²²¹ The earliest notices went to the deep-pocketed banks and brokerages, of course. Academia got a black eye when it was revealed that University of Michigan was in on the scheme. When New York attorney general Eric Schneiderman told Reuters to cease and desist, he ran into a remarkably remorseless opponent;²²² Reuters defended their private service and reserved the right to allocate data as they saw fit. This is not a bad argument, but Reuters terminated the practice (at least until the furor dies down). The odd pre-release trading disappeared.²²³

An interesting new form of media has emerged that is either the very beginnings of a media revolution or a skit in *Saturday Night Live*. Either way, I wanted a piece of that action, so I did an hour on BTFDtv.¹³ BTFDtv is an unscripted, unproduced, unprofessional, and at times very uncouth network of shows that live stream on the web. This new group was formed by a bunch of crazed traders who seem to share collective roots at Zero Hedge. Time will tell if this idea gets legs. Watch and just BTFD (buy the dips).

CNBC—Rise Above

“You shouldn’t be saying things you cannot prove....Fact? What’s a fact? I don’t like spewing things that are not actual facts on this program.”

~Maria Bartiromo, JPMorgan Chase spokesperson



@WilliamBanzai7

These media skills are like fools
They’ve broken old media rules
They don’t apply heat
But praise the elite
To help them abscond with our jewels

~@TheLimerickKing

These Banksy / Robert Frost wannabes are Twitter legends who crank this stuff out. I requested the media theme.

Every year I manage to pick a fight or two that is unnecessary, but I simply cannot resist. Let’s get right into it with CNBC. We are all sympathetic. Your ratings are tanking to 20-year lows in an up market.²²⁴ Although I am still smarting from my failed Twitter campaign to be a guest host on CNBC under the pseudonym “Joe Sixpack”, I must admit I really like some of the pundits. Kelly is great. Andrew, Becky, and Rick are affable. Liesman has his moments. Joe seems

to be recovering from his bout of Kudlowphilia and showing real signs of grasping the severity of the problems we must solve. Hobbs and Sedgwick should contribute to the unemployment stats.

Let's get to my really big gripe: You guys breathlessly announce earnings beats without a shred of useful information. A vast majority of your earnings are reported "ex-items." If those items are so dismissably rare, why do they appear *every* quarter from nearly *every* company? In the olden days you called them "pro-forma" earnings—earnings with embedded vendor financing deals, monetized eyeballs, and written down operating expenses. Pro forma earnings were bogus, and we had a train wreck to show for it. Well, you're doing it again. I've griped about "ex-items" to you guys directly via Twitter and gotten answers suggesting you "don't have time" or "talk about that a lot" or that "you make an excellent point". My favorite was, "I hear you, Dave, but it's what the market tends to trade on—what is delivered compared to what analysts expect." Apparently, these traders you speak of are trend followers who don't even care if the numbers are fake and are quite likely not human. The rest of us—the viewers who you hope will number in the millions—would like some truthiness.

Start afresh. Rise above. When you report earnings "ex-items" ask the following questions:

- (1) What were the "items" being excluded?
- (2) What was the dollar value of the exclusion?
- (3) Are you friggin' kidding me?

Provide the facts and you might get your viewers back. As it stands, only the algos and algo-like traders use the data, and they are not going to generate advertising revenues; you'll get lapped by BTFDtv if you're not careful. *CNBC—We deceive-you decide*. I think it's time for *you* folks to decide.

And while you're at it, work on some of the little stuff. Jerry Bowyer explains in "Confessions of a CNBC Optimist" that his job was to "body check" pessimists. One of Kudlow's bearish guests was subjected to such brutish behavior that the next guest on called it a "Sacco and Vanzetti interview." Brian Sullivan's attack on Elizabeth Warren was embarrassing,²²⁵ and he got outplayed. Calling Jon Hilsenrath a "Fed watcher" is like calling Heidi Fleiss a "date". Your series on "Market Masters" series could have been called "Pandering to Power". Also, could you *please* quit kissing Warren Buffett's ass so much? He is the greatest investor in the world, but the fawning gags me with a spoon.²²⁶ He is, after all, a deeply embedded insider with an unparalleled skill at gaming the system.

"Let's say you believe that China is making up the numbers. But if the stock market there keeps going up because of it, and you believe the government will keep priming the numbers, isn't that sort of a reason to bet on the Chinese stock market?"

~Brian Sullivan, CNBC

Yes, Brian, that is an excellent strategy if your goal is to be on the reality TV show *The Greater Fool*. Rise above...rise above...

Bankers and Finance

"I'm standing in one of New York's most crime-ridden neighborhoods. I'm standing on Wall Street."

~*The Daily Show*

"Financial Sector Thinks It's About Ready To Ruin World Again"

~Headline from the *Onion*

"They don't have a 'negative cash-flow position'. They're broke! They're fucking broke!"

~George Carlin

2013 seems like an off year for banking crimes. Of course, there was a steady stream of behavior that makes you want to lynch a bunch of them, but we witnessed volumes of follow-throughs of old scandals and very few new, really colorful ones. The high point of the year was when JPMorgan decided to communicate with the public via Twitter by encouraging questions using hashtag #askJPM. They got thousands—literally thousands—of the most truly raucous rhetorical questions you could imagine:

"I have Mortgage Fraud, Market Manipulation, Credit Card Abuse, Libor Rigging and Predatory Lending. AM I DIVERSIFIED? #AskJPM"

~Representative tweet to #askJPM

JPMorgan Chase was the major focus of the DOJ's catch and release program, rendering this syndicate the biggest headline grabber of the year. The sheer magnitude of JPM's trouble was foreshadowed by a \$28 billion slush fund set aside for legal problems.²²⁷ For weeks at a time you couldn't click Zero Hedge without seeing a new charge. Gretchen Morgenson and Bill Moyers suggested that the JPM board of directors needed stronger oversight, possibly removing oversight powers from the chairman of the board, Jamie Dimon. That would be the same Jamie "That's Why I'm a Bigger Douchebag Than You" Dimon who is JPM's CEO in desperate need of oversight. The idea that Dimon would be removed from the Board sent Bartiromo heels up (again) in his defense.

Lehman creditors sued JPM because the London Whale (Bruno Iksil) mismarked positions that led to an epic and apparently rather invalid \$8.6 billion margin call in '09.²²⁸ The most senior trader suggested that his group "stop reporting losses unless there was a market-moving event that could easily explain the losses." No

wonder bad news comes in clusters. The chief risk officer promoted fibbing about these trades, failing to grasp that a “risk officer” is there to *mitigate* risks.²²⁹ JPM discovered that some of the attacks against the Whale’s losing trades were coming from within the JPM itself—a form of autoimmune disease. The former CEO of a major banking subsidiary told me that he discovered traders “buying our own shit”.²³⁰ TBTF means too big to function I guess. JPM eventually threw a couple of expendable employees under the bus to clean up the Whale scandal, but at minimal inconvenience. (Temps were hired to vacuum the 12th and 13th floors.) I’m sure they were just legions of honest mistakes needing only an apology, but the DOJ insisted JPM accept guilt by publically declaring “my bad.”

JPM had to ante up some serious bucks for making Jefferson County, Alabama squeal like a pig owing to kinky derivatives deals that sent them into insolvency.²³¹ The robo-signing fine came due this year.²³² Good news: the dozen or more fraudulent “Linda Green” signatures at the center of the robo-signing controversy have all been indemnified;²³³ there is no mess that is too big to clean up with the stroke of the pen.

“If JPMorgan were just an average mook on the street, by now it would have been consigned for life to San Quentin”

~Saule Omarova, University of North Carolina School of Law

Whether it's the ethanol derivatives or the energy markets in general, the Enron-esque manipulation of commodity prices by JPM continues. (JPM has not yet rigged the aluminum and copper markets because Goldman controls those²³⁴ along with pornography,²³⁵ which they promptly sold once they got caught.) JPM’s rig-a-thon extended into the Forex markets,²³⁶ but they’ve seen the error of their ways. They’ve now moved the most dubious deals offshore, away from the long arm of the aggressive U.S. regulators.²³⁷ This is purely prophylactic; there are no regulators fitting that description.

JPM’s really big problems came in the form of gargantuan fines for their role in mortgage-backed securities. I must admit to being sympathetic to their supporters’ (Bartirromo’s) claims that these problems were baggage from Countrywide and Washington Mutual that JPM absconded with at steep discounts. Maybe the \$28 billion is just a claw back of the \$30 billion of Fed backing they garnered during the forced purchase of Bear Stearns. If so, the Fed stuck that landing like a Rumanian gymnast. Tax deductibility of the penalties added salve to the wounds of all but 100 million taxpayers.

“A billion here, a billion there, pretty soon, you’re talking real money.”

~Everett Dirksen, former U.S. senator

Many summaries of this criminal behavior have been penned, all of which have led to the expected number of prosecutions (zero).²³⁸ A few generic deeds of the banks are also worthy of comment. Fifteen states banned payday lenders,

prompting the banks to move the funding for them off shore. Six BofA employees accused BofA of shepherding homeowners into foreclosure rather than through the Fed-assisted mortgage restructuring. For the record, I think BofA had this one right (see *Housing*); nevertheless, the BofA whistle-blowers should get remote starters for their cars. Whistle blowing has become a dangerous career path; the truth no longer protects you from retribution. I return to this in *Civil Liberties*.

We discovered that BofA gives bonuses to employees who acquire high ranking government jobs, showing that the door truly revolves. A clause in his 2006 contract scored big for the new Secretary of the Treasury, Jack Lew, and probably much bigger for BofA.²³⁹ This is not surprising given Lew is in Robert Rubin's orbit. Insider trading in the Heinz acquisition was tracked to Goldman.²⁴⁰ Goldman's "Fabulous Fab" Fabrice Tourre went to trial and nobody cared.²⁴¹ After years of being called a lunatic, Patrick Byrne of *Overstock* was exonerated when emails surfaced showing that traders had indeed naked shorted his stock into dust.²⁴² (Naked shorting is illegal and *very* destructive to small cap companies.) S&P, a banking subsidiary euphemistically called a bond rating agency, defended against charges of fraud in its ratings by correctly arguing that the reports put out were mere "puffery" and not to be believed. That is true, but then they lost.²⁴³ That's an 0-for-2 ouch. Nomura got caught helping Banca Monte dei Paschi di Siena use derivatives to hide losses.²⁴⁴ In an Escherian way, Deutsche Bank used derivatives to cover up derivatives losses.²⁴⁵ The quadrillion dollar derivatives market, rich in counterparty risk, seems like the odds-on favorite to destroy the world, but for now it serves its purpose:

"Banks use derivatives they create to help their clients deceive the public. Other times, they enable the banks to deceive those clients."

~*New York Times*

Hank Greenberg *et al.* sued the Feds for an unlawful taking when the Feds essentially nationalized AIG.²⁴⁶ I'm taking Greenberg's side. Stockman describes in *The Great Deformation* how the bulk of AIG was fully cordoned off from its derivatives traders that supposedly would have brought it down. Reams of statutes insured (pun intended) that AIG would *not* have been dragged under, providing yet further evidence that The Great Intervention of '09 was both a colossal breach of capitalism and illegal. In a more general sense, the system should not have been saved in its current, highly mutant, form. Dean Baker provided a nicely phrased, sarcasm slathered, thank you to Tim Geithner, who just exited the private sector-sponsored public sector to buyout firm Warburg Pincus via the revolving door.²⁴⁷ There were tackier exit channels than that, but he will need a good tax accountant nonetheless.

"You're going to look like you're giving money to people who were responsible for burning down the economy."

~Tim Geithner, former head of the New York Fed

There's a story that is potentially big and hasn't gotten much coverage. Most know that Elizabeth Warren isn't a fan of the banks. She has criticized them for getting freebies from the Fed of \$85 billion per year. Warren and McCain have introduced a bill to break up the ginormous banks and bring back Glass-Steagall-like regulations.²⁴⁸ The untold story is that brilliant credit analyst Chris Whalen criticizes Warren for being off on her numbers—way off on her numbers. He claims that the central banks are actually giving them a monetary reach around of \$500 billion annually.²⁴⁹ Chris is not just some internet wingnut...or maybe he is now.

There is a ray of sunshine for the consumer. I got checks from TIAA-CREF for overcharging fees to my accounts. Quite the unexpected windfall gain: 0.002% of the balance. What legal costs were accrued prying *that* out of company's cold fingers?

"Due to recent overall decreases in interest rates and beginning on June 17th, 2013, interest paid on savings accounts will be reduced from .010% to .001%."

~Citigroup sign in a Tokyo bank

The financial industry is sending us a clear message stated succinctly by this 13-foot sculpture in front of Italy's stock exchange:



When the next crisis comes, consumers may have a message or two for the banks:

“If I had a rocket launcher some son-of-a-bitch would pay.”

~Bruce Coburn

The Federal Reserve

"The Fed has multiple tools."

~Ben Bernanke

Truer words were never spoken. The Fed seemed particularly unmoored this year. They have a balance sheet of nearly \$4 trillion and growing at \$1 trillion per year. We were promised the taper—a reduction in QE—and they seemed determined to do it, but then they went limp—not even the tip. What was *that* all about? Fed governor Richard Fisher openly stated that the failure to taper "did not reflect the discussion at the policy-setting table." Well, I guess that's what happens when you all put your heads down to vote. So they're printing a trillion dollars a year, and they don't know how to stop? But maybe they are not *really* printing money:

Congressman: "Is that printing money?"

Bernanke: "Not literally."

The congressman should try this one: "Is that creating money in some form?" Or how about, "Do we look so friggin' stupid as to not know why you used the term *literally* and that there is no ink or paper involved?" It would be great if there was some higher authority that could give me a little help on this one:

"In the common vernacular, that is termed 'printing money.'"

~Paul Volcker

Thank you. As you might imagine, I have reams and reams of quotes from various Fed governors and regional presidents collected throughout 2013, and I must admit that they baffled me. You get claims like this pair of gems:

"We're manufacturing [money] out of the blue...the monetary base is off the charts – absolutely off the charts... And, believe me, I'm the biggest inflation hawk."

~James Bullard, President of the St. Louis Fed

"We've got low inflation; that's why I'm not worried"

~James Bullard, President of the St. Louis Fed

Narayana Kocherlakota of the Minnesota Fed said that "monetary policy is too tight", whereas Dennis Lockhart hailing from the Atlanta Fed says, "this is an entirely new dimension of monetary easing, both in terms of quantity and quality". *Quality* money printing indeed! Lockhart expands on this at a later date

noting that “growth of the Fed’s balance sheet could have longer-term consequences that are worrisome.” Consequences of the highest quality no doubt. Lockhart also noted that “we only have a mandate to concern ourselves with the interest of the United States”, completely ignoring the written record showing that QE II (and more) went straight to Europe.¹⁷² John Williams of the San Francisco Fed, in a moment of great clarity, told us that “when house prices fall, people turn much more pessimistic about future house price appreciation.” Very wonky. He confessed that “asset bubbles are likely to be far more complicated than the simple and elegant rational models we have relied on.” You mean the models that are remarkably simple, not that elegant, and completely friggin’ wrong? Greenspan was a flawed model.

“The most notorious episode of monetary ease, however, occurred in July and August 1927, when Strong, though alarmed by the American market’s speculative and inflationary tendencies, nonetheless forced through the Federal Reserve system a decrease in the discount rate from 4 to 3 percent.”

Priscilla Roberts, Federal Reserve of Richmond, 2000

Richard Fisher from the Dallas Fed reminded us of a hilarious event from the dusty archives in which George Soros raided the British pound: “We haven’t forgotten what happened to the Bank of England. I don’t think anyone can break the Fed.” If there is a way to break the Fed, the guys at the FOMC will find it. My favorite was when Fisher described how “big money organizes itself somewhat like feral hogs,” reminding me of the mobsters who Fed a live victim to feral hogs, marveling at their appetites. Fed governor Jeremy Stein chastised buyers of corporate debt for “reaching for yield.” Now whose fault might that be?

All year I scrambled to piece together the Fed garble into a coherent picture with no luck, and then I had an epiphany: *It’s not supposed to make any sense*. Economist Vince Reinhart nailed it.²⁵⁰ He argues that in 1994, the Fed pushed for transparency by publishing the FOMC minutes, which promptly showed that the governors all sounded like imbeciles. This soon caused the discussions to become stiff, orchestrated, and altogether useless for real decision making. The Fed learned to cover up its foibles a la *Breakfast at Bernie’s*: the Fed would prop their completely incoherent Fed Chair (Greenspan) in a chair to babble “Fed Speak” at Congress. They branded this garbled dialect as a skill rather than just the bloviating incoherent Fed Chair working from flawed models. With Greenspan’s departure, the Fed desperately needed incoherence. The Fed discovered that a series of seemingly thoughtful statements from the individual governors, when put together, made no sense whatsoever. Shazaam! Total confusion.

This “orchestrated incoherence” is only a theory mind you. The Fed may just be a bunch of sub-average IQ types who are, collectively, an incoherent committee of academic bureaucrats. I do, however, think Bernanke is a smart guy despite his odd penchant for explaining the Great Depression without *ever* mentioning the role of bad monetary policy in the 1920s (at least in his public talks).

Being a smart guy, Bernanke sensed the ship taking on liquidity and grabs a lifeboat, which initiated a search for the next grand pooh-bah of the FOMC. Yellen took an early and decisive lead, offering Obama the chance to appoint the first female Fed chair. And then, without warning, the banks decide that Summers should come out of nowhere to steal the lead. *Larry Friggin' Summers?* Is this the same Larry Summers who said a Harvard student wearing a suit either had a job interview or is an asshole?²⁵¹ The guy who lost Harvard \$2 billion on crazy swaps deal?²⁵² The guy said by a colleague to be "uncontrollable"?²⁵³ Is he the guy who sent letters to Ken Lay of Enron pledging assistance in deregulating the energy markets?²⁵⁴ Yes, he is *that* Larry Summers, and it turned into yet more Obamarabilia. It became clear that, no matter how much Robert Rubin wanted Summers planted at the Fed, you couldn't put enough lipstick on that pig and you'd certainly *never* get it to fly. Obama had to suck it up and go back to Yellen, prompting Steve Liesman to call it "sloppy seconds. "Way to go Steve! How about another keg stand?

"Obama's senior economic advisers—still dominated by Clintonistas and aging acolytes of Robert Rubin—are pushing the president to choose Summers as the successor to Ben Bernanke, whose term ends in January. And they are urging Obama to make the announcement right now, before the opposition can get organized."

~William Greider, journalist and author of *Secrets of the Temple*

The next task was to do a little Yellen rehab and start deifying her in earnest. They *must* deify the FOMC chair because the banks require a Fed chair with the moral authority to do *anything the banking system wants no matter how destructive it might be to the rest of us*. The Fed chair cannot be questioned. Fed Governor Fisher leads off: "She's wrong on policy, but she's a darn good, decent, wonderful person." Whoa! Can we do a little better than that, Dick? The puff pieces by seasoned journalists on the White House payroll begin in earnest. Soon Yellen was brilliant, undeniably *not* sloppy seconds, and was the star who prevented the "panic of 2010", which is why nobody ever heard of the "panic of 2010". She became the only Fed governor to have seen the crisis coming and to call it right. If she did see it and did call it, she would certainly be the only one, but she didn't. Peter Schiff dissembled that myth by plowing through her speeches and showing that she was as clueless as any of them.²⁵⁵ The Age of Yellen is upon us, and that woman knows how to print money (but not literally).

Some of the smartest folks on the planet are screaming that the Fed is cornered. Books will be written on the subject. The Fed is rapidly approaching a fateful moment when it becomes the sole buyer of U.S. Treasuries. The Fed governors make hawkish speeches so that they can then go give dovish speeches and say, "I am the biggest inflation hawk but..." and then finish that phrase with some putty-headed statement demonstrating that they do not understand what is coming our way. They are basing policy on all those times in history that copious

money printing ushered in new eras of prosperity. Unfortunately, nobody has yet compiled that list and uploaded it to the internet yet.

“This Bernanke experiment will end in immense inflation”.

~James Grant, *Grant’s Interest Rate Observer*

I would like to defend Bernanke on one point. He is reputed to have said that he was 100% confident he could control inflation and attached a 15 minute time scale to it. What he actually said was that he could raise rates within 15 minutes, which is *literally* true. Readers who think the quality of the Fed’s balance sheet doesn’t matter should read Benn Steil’s description of how selling junk assets into the marketplace to contain inflation won’t work. And even all those tools at the Fed know that the law of diminishing returns is closer in the rearview mirror than it appears. Someday the monetary training wheels will come off, and you know what happens when the wheels come off. We are hobbled by the harsh reality that *none* of the Fed governors played Division 1 lacrosse.

“The Federal Reserve: We bailout so you don’t have to.”

Bootleggers

“I’m proud to be President of the United States”.

~Joe Biden, U.S. Senator

Following last year’s Baptists and Bootleggers theme, I will continue with a discussion of a few bootleggers who seem worthy of attention yet do not fall neatly into other categories—a few hand grenades lobbed for posterity. The bootleggers come from many strata, but they all generated a “WTF?”, “OMG!”, or “LOL”. They are not all bad. Some—Ray Dalio a case in point—just seemed to fall off the wagon briefly. The numbers are low because the Bootleggers who really get my goat are in government, big banks, central banks, and prison. (Actually, none of them are in prison.)

We begin with the crazy Norwegians in charge of handing out highly lucrative Nobel Prizes. Of course, the Nobel Memorial Prize in Economics was contentious to the uninitiated because it was given to a guy whose theories on efficient markets have not aged well (Fama). For those whose theories sound great but aren’t, we should give them the Nobel Participation Award. (To irate economists, I’m sure he’s a nice guy and great economist, but we simply don’t give prizes to chemists for sketchy theories.) The Peace Prize was particularly odd in that it was given to a fictional committee with no known members charged with preventing a past Nobel Peace Prize winner from bombing the hell out of Syria. Another new category, the Nobel PC Price, could go to Paul Tudor Jones for his comments about challenges women face in workforce after having spawned children.²⁵⁶ (Tudor was really more of a Tudor Turtle on that one.)

I think the world of Ray Dalio and have heaped considerable praise on him in the past. However, he seemed to go inexplicably soft. I began to suspect he was looking for a cabinet-level position in the Obama administration; he didn't, but the absence of evidence is *not* evidence of absence. His comments about how we are in a "beautiful deleveraging"—a combination of inflation and deflation that will guide us to the promised land—seemed insensitive to those incapable of buying travel insurance (hedging) for this long and costly journey. A beautifully produced 30 minute video glossed over the pain incurred by the 99%.²⁵⁷ An unrelated shocker came when Ray stated, "Ironically, by increasing your risk in the bonds you are going to lower your risk in your overall portfolio"²⁵⁸ OK, but how do you achieve this lower risk? By using leverage in your bond portfolio! The article brings it home with the money shot from a supporter of the thesis: "Proponents say it is risky not to use leverage." I disagree but have no creds to stand on. The good news-bad news is that leverage already in the bond market suggests that we are going to do the experiment. The very premise that bonds and stocks move in opposite directions seems to fly in the face of data from the 1970s.

CNBC's most watched sequence occurred when Bill Ackman and Carl Icahn brawled during primetime.²⁵⁹ It was ostensibly about Herbalife (Ackman short, Icahn long), but it more looked like two guys having a pissing match writing epithets in the snow. (DNA tests showed an odd inverse correlation between the handwriting and the urine source.) I'm sure Ackman has some bootlegger qualities, but it would be hard to root for Icahn. (One of his peers refuses to even eat a meal with him.) In any event, Ackman soon found that many of his positions—long or short—mysteriously turned hard south. Icahn licked Ackman, and Ackman licked wounds. I think the message is do not piss off a mean bastard worth a gazillion dollars while other billionaires stand around placing huge bets on the fight. As an aside, I do not short stocks but Herbalife seems poised for a plummet now that Ackman and weak-knuckled imitators got squeezed out. Ackman gives Herbalife a one-year life expectancy, ironic for a health supplement company.

Stevie Cohen of SAC Capital got beat up pretty fierce this year. He's not going to jail (of course), but District Attorney Preet Bharara appears to have extracted some serious Bitcoin out of him (>\$1 billion) as well as put a stake in SAC's heart.²⁶⁰ Patrick Byrne, still smarting from the pain of naked short sellers beating down Overstock.com (maybe Stevie Cohen?), took out a full page ad to mock him: "Shooting SAC Capital dead and throwing all of its employees into the street is civilization scraping some dog shit off its shoe."²⁴² Catchy prose, Patrick. Citigroup was fined \$30 million for sending Cohen *et al.* insider information.²⁶¹ The fine was kept low given Citi is already a ward of the state. It would appear that Stevie did not follow Corzine's lead and bundle campaign donations for the guy calling the shots. Jeff Sachs suggests that the bundling *did* get him some serious slack.²⁶²

I, by the way, think NY District Attorney Preet Bharara is (or will be) a bootlegger too. He went to a few too many hedge fund conferences.²⁶³ Politically ambitious NY District Attorney's pissing off the richest guys in New York have

always struck me as paradoxical. My crystal ball sees a political career for Preet as early as 2016. I wonder who's funding the campaign...

Greenspan, no longer in the Central Banker category, drew scorn for his new book entitled, *The Sap in Purgatory: Risk, Human Screw-ups, and the Future of Forecasting Without a Clue* (or something like that). Let us just say that everybody—*everybody*—agreed that he has overstayed his welcome. Bill Fleckenstein, hedge fund manager and coauthor of *Greenspan's Bubbles*, summed up his own views succinctly: “lock me in a room with that scumbag”.

A few others get comments in rapid fire. David Tepper has grown fond of the limelight. He waxed bullish on CNBC while contemporaneously liquidating some large positions.²⁶⁴ Maybe he was rebalancing. Al Gore sold his small network to global-warming Al Jazeera.²⁶⁵ There's something odd about that one. Greg Mankiw defended the 1%.²⁶⁶ I do too if we are talking about the Titans of Industry who build nations, but that was not Greg's slant. He declared he would not respond to his critics (bad idea), and then the link went dead, but not before the diatribes made it to press.²⁶⁷ Steve Schwarzman of Blackstone denounced raising the 15 percent taxes on much of their income by suggesting “It's a war; it's like when Hitler invaded Poland in 1939.”²⁶⁸ Invoking Hitler to win a debate is covered by Godwin's Law:²⁶⁹

Godwin's Law: As an online discussion grows longer, the probability of a comparison involving Nazis or Hitler approaches 1.

Steve Rattner admitted to directing funding of some GM pension plans and not others during their bailout and restructuring.²⁷⁰ His image rehab is taking a little longer than he had hoped. AIG's CEO Bob Benmosche stepped in it again when he said that “outrage over banker bonuses was intended to stir public anger, to get everybody out there with their pitch forks and their hangman nooses, and all that - sort of like what we did in the Deep South. And I think it was just as bad and just as wrong.”²⁷¹ Godwin's Law 1.0.1 covers civil rights analogies.

“After four and a half intense and wonderful years as CEO of Groupon, I've decided that I'd like to spend more time with my family. Just kidding - I was fired today. If you're wondering why... you haven't been paying attention.”

~Andrew Mason, CEO of Groupon

Now *that* is a bootlegger!

Paul Krugman

“When they created the Euro they created a thing like the gold standard.”

~Paul Krugman on good fiat currencies

"I think forming the Euro was a mistake, but it's a very different thing to say it should never have been done"

~Paul Krugman on bad fiat currencies

Paul Krugman gets his own section, and Paul's detractors may get a chuckle. That group, by the way, is headed by Niall Ferguson who got in a slugfest with Paul this year²⁷² and David Stockman who seems to deeply appreciate Krugman-quote-laden emails. Although I will never win the Nobel Prize in Chemistry, Paul gives me hope that there is a Nobel Prize in Something out there with my name on it. He is the blogger's gift that keeps on giving. His horsemeat-laced nuggets have made me clean up the aftermath of more snot bubbles than any public figure. I don't recommend reading them all (actually I do) but they are a stunning display. Without further ado, I offer this *Collectors Edition of Paul Krugman's Greatest Quotes of 2013*. I salt in a few oldies for flavor and context.

"People talk about waste, fraud, and abuse. There isn't a whole lot of that in the U.S. government, except in defense."

~Paul Krugman on efficiency of government

"We should have been able to get all the relevant parties in a room and say, look, this inflation has to stop; you workers, reduce your wage demands, you businesses, cancel your price increases, and for our part, we agree to stop printing money so the whole thing is over. That way, you'd get price stability without the recession."

~Paul Krugman on the '70's inflation

"Higher personal savings is really bad for the economy"

~Paul Krugman on the paradox of thrift

"Stuff that's now being called "currency wars" is almost surely a net plus for the world economy."

~Paul Krugman on Beggar Thy Neighbor policies

"European economy works; it grows; it's as dynamic, all in all, as our own."

~Paul Krugman in 2008 on the European juggernaut

"We tended to reduce our debt when the economy was strong."

~Paul Krugman referring to all but the last 61 years

By 2005 or so, it will become clear that the Internet's impact on the economy has been no greater than the fax machine's."

~Paul Krugman in 1998 on passing fads

"As the rate of technological change in computing slows, the number of jobs for IT specialists will decelerate"

~Paul Krugman on poor career choices

"Food and gas prices are not driven by Ben Bernanke."

~Paul Krugman on the source of inflation

"I'm terrified about what will happen to interest rates once financial markets wake up to the implications of skyrocketing budget deficits."

~Paul Krugman in 2003 slipping up and making a valid point

"So, have you heard the one about the trillion-dollar coin? It may sound like a joke. But if we aren't ready to mint that coin or take some equivalent action, the joke will be on us—and a very sick joke it will be, too."

~Paul Krugman on the \$1 trillion dollar platinum (Bit)coin

"He's just ruining his own brand."

~Paul Krugman countering Jon Stewart's vicious claim that a \$1 trillion coin is "making shit up"

"Thrift leads to lower investment; wage cuts reduce employment; even higher productivity can be a bad thing. And the broken windows fallacy ceases to be a fallacy."

~Paul Krugman on the destructive power of saving and productivity

"Maybe I actually am right, and maybe the other side actually does contain a remarkable number of knaves and fools."

~Paul Krugman on his detractors

"...being proved wrong but continuing to loudly assert the same thing again and again regardless."

~Krugman on the definition of "Derps" from "Derpistan"

"America really does have a weird broccoli addiction...my favorite vegetable is arugula."

~Krugman in NYT on the history of General Tso's Chicken

"I believe that all of these positions are misguided."

~Jeffrey Sachs on Paul Krugman

Baptists

"I do expect the S&P to go below 666. I expect absolute carnage. But I'm more bullish than I was."

~Albert Edwards

"Albert Edwards, the famously bearish Societe Generale strategist, has turned more bullish"

~Yahoo Finance Headline

I didn't know whether to put that pair here or in the media section. Oh well. Every year I like to give a hat tip to the Baptists, the folks calling for their brethren to get some religion. Some are perennial, but we lose and gain a few each year. I'll let them speak for themselves with minimal additional comment. Are they right? Nobody knows for sure, and they are all mortals. If we wake up in 2024, however, having experienced 24-year-long Japanese-style lost decade we were warned. In the least, the quotes are blogger porn.

"Japan is near the point where they just can't borrow anymore...there is nowhere to go....We believe that war is an inevitable consequence of the current global economic situation."

~Kyle Bass, Founder of Hayman Capital

Kyle is a versatile bear, but he has a serious Japanese fetish. A colleague watched one of his talks and promptly bought gold. You should watch at least one of them.^{19,273,274}

"It's not a free market. It's not a clean market.... The market isn't saying anything about the future. It's saying there's a phony buyer of \$19 billion of Treasuries a week...I see a storm coming, maybe bigger than the storm we had in 2008, 2010....the demographic bubble I was looking at way back in '94 that started in 2011, we are right at the first ramp-up of this thing that is about to hit."

~Stanley Druckenmiller, Founder of Duquesne Capital

The normally camera-shy Wall Street legend, Stanley Druckenmiller, came out repeatedly to denounce the distortions. He declared in so many words that he is mad as hell and isn't going to take it anymore. He gave his investors' money back in 2010.

"There's no one in the stock market today except drugged up day-traders and robots... This is utterly irrational...how could someone in their right mind believe that you can have interest rates... at zero for nine years?...we're almost on the edge of another explosion at the present time."

~David Stockman, Former Reagan Economic Advisor and Blackstone Group

Stockman is prolific. You could fill a 600 page book with his vivid quotes, and he did. It is listed in the book section at the end.

"I'm sorry, America. As a former Federal Reserve official, I was responsible for executing the centerpiece program of the Fed's first plunge into the bond-buying experiment known as quantitative easing. The central bank continues to spin QE as a tool for helping Main Street. But I've come to recognize the program for what it really is: the greatest backdoor Wall Street bailout of all time....We were working feverishly to preserve the impression that the Fed knew what it was doing....You'd think the Fed would have finally stopped to question the wisdom of QE...the Fed announced a new round of bond buying...Wolfgang Schäuble immediately called the decision "clueless." That was when I realized the Fed had lost any remaining ability to think independently from Wall Street...Fed is at the center of that dysfunction... It has allowed QE to become Wall Street's new "too big to fail" policy."

~Andrew Huszar, former Morgan Stanley administrator of QE1

Andrew ran the \$1 trillion dollar QE program.²⁷⁵ This is an astonishing confession and a must read in its entirety.

You've got to look behind the markets to see what is happening....We don't know when the storm is gonna hit but it has to happen...when you look at our debt to GDP eventually you reach a point where there is no turning back...this is a rape of unborn children: it's generational theft of an enormous magnitude..."

~Ken Langone, Founder of Home Depot

There were rumors that Langone brought down Spitzer, but that is probably just internet noise. He does indeed appear to be a tough guy.

“We have seen extraordinary, heretofore unimagined, feats of money printing and interest rate suppression by not only our central bank but almost all of the major ones, and people have become complacent.”

~James Grant, *Editor of Grant's Interest Rate Observer*

Jim is so smart and scholarly about monetary history that he is the only permabear who can go on CNBC and get them all to shut up (STFU).

“Policies that misallocate savings away from productive investment and toward unproductive speculation are the same policies that do long-term violence to our nation's standard of living.”

~John Hussman, Founder of Hussman Funds

John uses a remarkably patient valuation strategy by looking at equity returns ten years out. His clients must be faithful, because it is not the optimum marketing ploy while the markets remain frothy. But when they turn...

“This is a mathematical fact. Tens of trillions of dollars is being extracted from the United States of America”

~Dylan Radigan, former CNBC host

Dylan left the stage this year to chase interests in hydroponic farming, but before doing so he did what the psychologists refer to as “going completely bat shit.” This is a must-see rant.²⁷⁶

“Big banks should be tasked with the job of deciding how best to split themselves up”

~Brooksley Born, former head of the Commodity Futures and Trading Commission

Brooksley attempted to bring derivatives trading under regulation in the late 90s, but was mugged by the Committee to Destroy the World (Summers, Greenspan, and Rubin) in Congressional hearings. *Frontline* did a brilliant, must-see expose' on this fateful moment in history.²⁷⁷

“The recent trading environment has felt something like walking into a place and having a sense that something is wrong and dangerous but not knowing exactly what will happen....QE Infinity has so distorted the prices of stocks and bonds that nobody can possibly determine what the investing landscape would look like, or what the condition of the economy and financial system would be, in the absence of Fed

bond-buying....The markets' ability to withstand any adversity is highly questionable, and it appears to us that the Fed is basically paralyzed"

~Paul Singer, founder of Elliott Management Corporation

Singer is an elite hedge fund manager annually invited to the Ira Sohn Conference.

"I see nothing in this environment inconsistent with my view that this is the biggest, most precarious bubble in history."

~Doug Noland, senior portfolio manager at Federated Investors

Noland is a brilliant credit analyst who documented the credit bubble from the late '90s with unparalleled thoroughness and clarity in his weekly Credit Bubble Bulletin.²⁷⁸

"Wall Street has run the White House for the last 15 or 20 years..and has made quite a mess of things."

~Jeff Sachs, globally prominent economist at Columbia University

Sachs is a mainstream economist who normally seems rather optimistic. He showed up on the airwaves repeatedly, with a vengeance, and without notice in 2013, warning of dire problems within the system.^{262,279} I recommended him to our business school dean for the "ethics lecture".

"This is the first time in recorded history that all major central banks have been flooding the market with artificial money printing...trying to debase their currencies at the same time."

~Jim Rogers, Founder of Beeland Capital

Rogers is now a permabear. He is a tough interview: you throw him a lob pitch and he declares it a stupidly obvious question before answering it. But he's direct and grizzled and a former partner of George Soros.

"If the economy is so fragile that the government cannot allow failure, then we are indeed close to collapse. For if you must rescue everything, then ultimately you will be able to rescue nothing."

~Seth Klarman, founder of Baupost Group

Klarman's militancy has reached new levels: I have too many brilliant quotes to chose from.^{280,281} He gave money back to investors for only the second time in Baupost's history.²⁸²

“Lost in the angst over inequality is the critical role that central banks have played in exacerbating the problem.

~Stephen Roach, Yale and former executive director of Morgan Stanley

Roach was one of the original bears who saw big messes in the making more than a decade ago and still retained his job in a major brokerage house.

“We are in the middle of an epic credit bubble, in my opinion, the likes of which I haven’t seen in my career in private equity.”

~Joseph Baratta, head of Blackstone’s Private Equity Group

Interesting candor given that these guys live and die by a leveraged financial system.

“Tell me about the last few times you have taken the big Wall Street banks all the way through trial...my question is when *did* you take them to trial?

~Elizabeth Warren, U.S. senator

I wrote a couple of blogs for Elizabeth before her political fame. My ability to endorse Ron Paul on his official 2008 presidential website *and* be a “self-confessed groupie” of Warren caught the attention of the *Guardian* and my neurologist.¹² It’s quite simple: I think they are both honest.

“As more lives and communities are destroyed by the system that creates vast amounts of wealth for the few, the more heroic it sounds to 'give back.' It’s what I would call 'conscience laundering'—feeling better about accumulating more than any one person could possibly need to live on by sprinkling a little around as an act of charity. We’ve got a perpetual poverty machine. It’s an old story; we really need a new one.”

~Peter Buffett

Yes, that was indeed Warren Buffet’s son.²⁸³ Last year I quoted Warren’s dad beating Warren about the head and face for Warren’s self-serving views about gold.^{1,2}

“Goldman has to be changed from the outside. The market could do it, but the government is standing in the way.”

~Michael Lewis, author of *Moneyball*, *The Big Short*, and *Liar’s Poker*.

I'll read *anything* Lewis writes and watch *any* podcast. His ability to find the narrative within the story is unparalleled.

(1) How much does QE contribute to the growing inequality of wealth in this country and what are the risks this creates?
(2) How much systemic risk does the Fed create by becoming what Warren Buffett termed 'the greatest hedge fund in history'?
(3) How might the Fed's expanded balance sheet and its failure to even begin to 'normalize' monetary policy four years into the recovery limit its flexibility to deal with the next recession or crisis?

~David Einhorn, CEO of Greenlight Capital

Some view Einhorn as one of the dark lords of the hedge fund world. Others know better.

"The Fed is really playing a dangerous game...I want them to stop. They should knock this off. This is bad. This is a heroin addiction. This is not good. This is not smart."

~Barry Sternlicht, founder and CEO of Starwood Capital Group

This interview left Joe Kernan—*Joe Kernan*—speechless.²⁸⁴

"The odds are that the world is experiencing a bigger bubble than the one that unleashed the 2008 global financial crisis."

~Andy Xie, former Morgan Stanley

Xie lost his job as Morgan Stanley's Asian guru when an internal email slathered with candor leaked to the outside world. It's a fascinating read.²⁸⁵

"The higher we go, the less surprised I will be to see the stock market crash. How big a crash could we get?...40%–55%."

~Henry Blodget, *Business Insider*

The Henry Blodget? Yes. He's channeling John Hussman in this quote, but he's done a nice job at building *Business Insider*, which I find contentious but addictive.

"Two percent inflation will halve the currency in 20 years; it's not my definition of price stability"

~Paul Volcker

We need another Paul Volcker, not a Greenspan, Bernanke, or Yellen. As Yoda said, "There is another."

Government Gone Wild

"A government in which political power is for sale to the highest bidder puts the wealthy at an extreme advantage, as they have the means to buy political power to conserve and expand their share of the national income."

~Charles Hugh Smith, OfTwoMinds.com and one of my favorite bloggers

Eric Holder and Lanny Breuer. I put a bat to Holder last year. His feckless pursuit of criminal elements—his dogged determination to protect them—inspired one big "heckuva a job, Eric" out of me. For a guy who started adulthood as a militant campus radical,²⁸⁶ he sure morphed into a cog within that which he opposed. He left open the option on drone strikes against American citizens,²⁸⁷ faked statistics on fraud cases brought to trial (but only by a factor of five),²⁸⁸ prosecuted a government official in a bribery case but left the deep-pocketed banker unscathed,²⁸⁹ illegally recused himself from a case without providing a reason,²⁹⁰ failed to respond to a child pornography ring of government employees, and admitted that some banks are too big to risk prosecution. Holder signed off on a subpoena that went after a Fox news reporter's private emails calling the target "a possible unindicted co-conspirator."²⁹¹ Fifty Congressmen signed a letter asking for Holder's demotion to "unemployed".²⁹² Holder is really more of a placeholder, but he is still employed.

We got some excitement when *Frontline* aired the exposé entitled, *The Untouchables*.²⁹³ It is a must see. Assistant Attorney General Lanny Breuer argued that "I don't accept for one moment that you all are finding whistle-blowers that we're not." The plot thickened at precisely the moment when the highly expendable Breuer admitted that some banks were too risky to prosecute:

"If I bring a case against institution A, and as a result of bringing that case, there's some huge economic effect...it's a factor we need to know and understand."

~Lanny Breuer, assistant attorney general on *Frontline*

Well, there was indeed a ripple effect because the following Monday Lanny announced that he would be spending more time with his family.²⁹⁴ He then promptly took a job at Covington and Burling (former employer of Eric Holder) for an estimated \$4 million per year,²⁹⁵ establishing the market price of family time.

Lois Lerner. A mild-mannered IRS commissioner found herself sitting in the hot seat when it was discovered that IRS agents had targeted right-wing

organizations as conspiracy theorists in the tea party had been alleging. What started as a rogue agent was soon working its way toward the White House. A Freedom of Information Act (FOIA) suit retrieved records showing 157 visits by Ms. Lerner to the White House,²⁹⁶ which is probably close to Cheney's count when he was acting president. She made the Football Hall of Fame for biggest fumble when, *as Commissioner of the IRS*, she claimed under gentle questioning by Congress, "I am not very good at math."²⁹⁷ She tried to "plead the fifth" but then said something that negated her plea.²⁹⁸ Oops. It's under the bus for you, lady! Lerner went on "administrative leave" in May.²⁹⁹

Epilogue: It is claimed that the tea party still has tax problems. The irony of it all is that the tax exemption of *many* political organizations should probably be questioned. The really twisted part is that some suspect that Obama released the IRS scandal to douse the flames of the Benghazi scandal. If all this were not funny enough, there was an IRS micro-scandal in which IRS employees partied their asses off on the taxpayers dime and, when questioned, announced they had lost their receipts!³⁰⁰ You can't make this shit up.

Mary Jo White. As previous SEC head Mary Shapiro took the revolving door to high income at Promontory Financial Group, the new head of the SEC, Mary Jo "M-Jo" White, took her place. Technically M-Jo should not be in this section *yet*, but I am taking out a put option on her stay at the SEC. Joe Saluzzi and Sal Arnuk, Wall Street veterans and authors of *Broken Markets*, wrote an open letter to her begging her to unbreak the markets. Their need to send such a letter is telling. Chris Whalen seems to like her,³⁰¹ whereas Matt Taibbi makes a case she will be a "Wall Street darling".³⁰² Bloomberg's Jonathan Weil paints a grisly picture of White's conflict of interest with payouts to M-Jo by her current white-shoe law firm that will continue in perpetuity.³⁰³ One of her earliest policy moves was to authorize hedge funds to advertise.³⁰⁴ I concur with the decision—the Supreme Court already dealt with that one in the context of lawyers—but am confident it will produce the sequel to *Boiler Room*. Despite the usual wave of puff pieces of little value that preceded her first day at work, the *New York Times* editorial staff appears to have planted their flag in the camp of doubters.³⁰⁵

Government Shutdown. This section will be short, not for any partisan reason but because I find it difficult to talk about. On the one hand, you have a government totally out of control for which a kill switch on the machine seems appropriate. On the other, the guys shutting it down seem like a bunch of D-bags. I am not apathetic—they threw my entire research program into limbo and did irreparable harm to some federal research programs when the laboratory animals had to be euthanized. (That, by the way, is what is called a "First World problem".) They all seems hopelessly incorrigible. On a humorous note, the U.S. Treasury's solution was to start tweeting:

"Congress should act as soon as possible to meet its responsibility to the nation and remove the threat of default"

~Treasury Department @USTreasury

Revolving Door. The unholy alliance between finance and government has been referred to as “soft corruption” because it is nearly impossible to trace the quid pro quo payments after leaving office to deeds while in office. Geithner’s leaks to big banks during the crisis appeared to be significant and profitable for some.^{omit}²⁴⁷ Robert Khuzami, the former enforcement director at the SEC, has cashed in his chits for a \$5+ million salary at Kirkland & Ellis, a prominent Wall Street law firm.³⁰⁶ There are so many examples. I’ve seen estimates that 50% of political and politically connected folks leave via the revolving door. I guess they’ve gotta work, but the soft corruption seems undeniable.

Miscellaneous. Halliburton was convicted of destroying evidence about the Deepwater Horizon oil spill. Maximum fine: \$200K.³⁰⁷ Congress found itself “not guilty” for taking loans from Angelo Mozillo.³⁰⁸ Interior secretary under George Bush, in an oddly poetic scandal, was said to have spent \$200K of our money remodeling his bathroom, making him Interior Design Secretary.³⁰⁹ The real scandal in Washington isn’t what’s illegal but what the snollygosters in Washington can do legally. This is described in the book *This Town* listed in the books section below.

Pondering the words from a Joe Sixpack of Yore to an Elder Statesman is instructive:

“If you had the right to give anything, the amount was simply a matter of discretion with you, and you had as much right to give \$20,000,000 as \$20,000. If you have the right to give at all; and as the Constitution neither defines charity nor stipulates the amount, you are at liberty to give to any and everything which you may believe, or profess to believe, is a charity and to any amount you may think proper. You will very easily perceive what a wide door this would open for fraud and corruption and favoritism, on the one hand, and for robbing the people on the other. No, Colonel, Congress has no right to give charity.”

Old Farmer to Congressman Davy Crockett

Mr. Obama Goes to Washington

“We don’t have a domestic spying program”

~Barack Obama on Jay Leno

I try to keep this review non-partisan or at least hurl nasty bipartisan epithets, but I think it is a bipartisan view that the Potus had a particularly bleak year. *Obama supporters and IRS auditors should skip to the next section; I am not trying to piss you off.* On further reflection, *everybody* could skip to the next section, but a 2013 Year in Review simply *must* confront President Obama’s problems.

Despite his oratory skills and affability, his roots in the Chicago School of Politics leads me to suggest at the outset that he was not pristine.^{1,2,3,4} This year ushered in some truly disturbing stuff, however, causing his approval ratings to drop below those of a crack-headed mayor of Toronto. Those looking for hope and change seemed to get neither. I did *not* vote for him, but I am highly sympathetic to those who did. Liberal democrats including Michael Moore, Matt Damon, Bill Ayers, Cornell West, and the ACLU turned on him.

“I think of this as President Bush’s fourth term.”

~Ari Fleisher, White house press secretary for George Bush

The year started out generically with the Benghazi fiasco in which Obama boned it badly by not providing support to an embassy. Lives were lost, and then he tried to cover it up.³¹⁰ That’s standard fare for a president these days. But the tide just kept rising and sands kept shifting. The IRS-gate (see Lois Lerner above) had White House fingerprints all over it. The journalist phone hacking scandal was nasty but short lived. The White House defended hoovering up Verizon phone records to fight terrorism. (Catch that Hoover double entendre?) This story got some serious legs when a high school graduate, aficionado of fine strippers, and NSA analyst Edward Snowden entered the scene (vide infra).

The Affordable Care Act—ACA or Obamacare—ironically turned into a third trimester abortion. A website that could have been put together by a couple of kids from Palo Alto High was contracted out to one of Michelle Obama’s Princeton contemporaries³¹¹ for \$500 million and appears to have thrown the entire healthcare system into a tailspin. The key promise—we didn’t have to participate if we didn’t want to—turned out to be a very big lie.³¹² Now we have millions without healthcare or with significantly more pricey healthcare. The head of it all, Kathleen Sebelius, still has her job. (Her maiden name was Gilligan, apparently unbeknownst to the *Daily Show* writers.)

“I will provide our intelligence and law enforcement agencies with the tools they need to track and take out the terrorists without undermining our Constitution and our freedom.”

~Barack Obama, 2008

A book by Jeremy Scahill entitled *Dirty Wars* (see *Books* below) describes the modern U.S. war machine. Scahill, no right-wing hack by any measure, said that Obama was statistically more hawkish than George Bush the Younger *in every category*. Obama promised to get rid of Guantanamo, which many inferred did *not* mean setting up a new gulag elsewhere, but it never came to pass. The NDAA, the Snowden affair, and drone warfare are so egregious that they get relegated to the section on *Civil Liberties*.

And then there's Syria. In an odd parallel with the HBO series *Newsroom* in which our troops supposedly used sarin gas, Bashar al-Assad reputedly used it

against the Syrians.³¹³ Assad had every weapon pointed at his head so you would *not* have predicted that. Subsequent evidence surfaced that it was not his call³¹⁴ or not even Assad's troops.^{315,316} Nevertheless, Obama had this terrible hankerin' to bomb Syria for reasons we will never be privy to (although natural gas may be involved), but he realized he was in political trouble.³¹⁷ First the White House tried to dial it back with Kerry announcing that America would launch an "unbelievably small and limited effort" to punish the Assad regime.³¹⁸ Nothing says I love you like a cruise missile. Then Vladimir Putin pulled off some diplomatic moves that were savvy for a treacherous commie bastard:

"The United Nations' founders understood that decisions affecting war and peace should happen only by consensus...The profound wisdom of this has underpinned the stability of international relations for decades...No one doubts that poison gas was used in Syria. But there is every reason to believe it was used not by the Syrian Army, but by opposition forces, to provoke intervention by their powerful foreign patrons"

~Vladimir Putin, *New York Times*

Conflict was preempted at the last minute by some malarkey about a Committee to Save the World (a different one) that would disarm Syria.²⁵⁷ Phew. That was close. We almost killed a pile of Syrians trying to prevent them from killing a pile of Syrians. It sure seemed like bombing Syria was a really stupid idea.

Obama's Wall Street supporters were constantly embarrassing him with their looting and pillaging. I think his truly colossal failure as president will prove to be his unwillingness to rein in the banking sector when the window of opportunity knocked in '09. Matt Taibbi referred to him as the "architect of too big to fail",³¹⁹ although that seems like too much credit. He did, however, choose to save his top fundraiser, John Corzine, all the banks, and anybody else of wealth and power. I am oddly optimistic that he will be offered another crisis to justify reining them in as the market decides to test Yellen's resolve.

Potus signed a few dubious bills including one that protects Monsanto against all torte actions pertaining to genetically modified organisms (GMOs),³²⁰ one that allows Congress to not disclose their financial holdings,³²¹ and one that facilitates prosecution of whistle-blowers.³²² He has been beating on the media with a rolled-up copy of the Constitution, threatening—of all people—Bob Woodward.³²³ His administration ducked FOIA requests about the seemingly dubious Bin Laden raid by moving files to the CIA,³²⁴ which they then dealt with using standard embassy methods.

I am no liberal democrat, and Barack Obama is no Jack Kennedy. The good news is that the 150 rounds of golf must have dropped his handicap to parity with the 10-year bond yield.

Civil Liberties, Part 1

"It is hard to imagine a more stupid or more dangerous way of making decisions than by putting those decisions in the hands of people who pay no price for being wrong."

~Thomas Sowell

"Tyrants preserve themselves by sowing fear and mistrust among the citizens by means of spies, by distracting them with foreign wars, by eliminating men of spirit who might lead a revolution, by humbling the people, and making them incapable of decisive action."

~Aristotle

Every year I write about civil liberties. It's a personal need I guess. This is a decaying plotline with 2013 offering up some particularly poignant and at times gruesome instances in which the freedoms of individuals conflicted with awesome power of the state. We found ourselves immersed in "secret programs approved by a secret court, issuing secret court orders, based on secret interpretations of the law" as described by one U.S. senator. I've cordoned off what seems like the routine breaches of constitutionally granted freedoms (part 1) from the special case of Edward Snowden versus The National Security Agency (part 2). We have nothing to fear if we are not doing anything wrong, right? Ask former Soviet citizens how that worked out. We're not worried about our privacy? Put your diary online.

There is a fine line here: Where does whistle blowing end and traitorous acts begin? We should err toward the former. In any case, it was an ominous year for whistle-blowers, and it seems likely to worsen. I have quaint recollections of whistle-blowers protected by the truth. Once the whistle had been blown, the storyline moved from whistle-blower to the abuser of power. Nowadays whistle-blowers, whether government or corporate, are dealt with severely, apparently to send a message to wannabes that tattling on the powerful is a poor career path. NY Fed employee who blew the whistle on Goldman got fired.³²⁵ Thomason Reuters employee who went to the FBI with information about the early releases of the Michigan confidence data was fired.³²⁶ Aurelia Fedenisn, a former State Department inspector general investigator, shined a light on alleged wrongdoing by U.S. officials around the globe and had law enforcement officers camp out in front of her house.³²⁷ Bradley Manning paid a dear price for his disclosures. I am less clear on this one, but the message is still clear: go to the press and spend life in prison.³²⁸ Obama DOJ forced reporter Jim Risen to testify against CIA whistle-blower.³²⁹ That gentlemen had some choice descriptions of torture tactics used in prison.³³⁰

This is your life, this is your country - and if you want to keep it safe, you need to get involved.

~Aaron Swartz, 1986-2013

The untimely death of Aaron Swartz captured hearts and minds of many.³³¹ Swartz, a boy genius who seems to have been a suicide risk owing to mental illness, organized a grass roots movement in a matter of days to shut down the heinously oppressive SOPA³³² discussed in last year's review.¹ He got himself in a bit of hot water when he did a high-bandwidth dump of academic articles into the public domain from MIT servers. Whereas MIT promptly covered its ass,³³³ Swartz was unable to do so. It was bad judgment, possibly illegal, but in no way profitable or destructive. Nevertheless, a zealous prosecutor with his own skeletons—a childhood murder conviction sealed by the court—over-charged Aaron, looking to put him away for decades. The best case scenario was \$1.5 million in legal fees and an acquittal.³³⁴ Swartz snapped from the pressure and hanged himself. This may be the prosecutor's second such suicide.³³⁵

We move to the next untimely death, that of Michael Hastings.³³⁶ Hastings was a prominent journalist, also showing signs of state-induced stress. He was working on a story about the FBI and they were working on a story about him.³³⁷ He became exceedingly agitated by what he believed was intrusive surveillance. He died in a one car accident that *he* thought was suspicious. Say *what*? Yes indeed. Michael unsuccessfully tried to borrow his neighbor's car that night, claiming that his car had been tampered with.³³⁸ Forced to use his own car, he drove off into a fiery demise. Very odd, but this is probably just another conspiracy theory.

Then there was the dreaded George Zimmerman case. Was it cold blooded murder of a Skittles-toting kid or self-defense by a guy getting pummeled by a 6' 2" street brawler? Although I am intrigued by a video synopsis by Stefan Molyneux,³³⁹ this is not the Michael Lewis narrative I care about. The power of the state was a subplot: the prosecutor *organized* anti-Zimmerman protests,³⁴⁰ sued Alan Dershowitz and Harvard for criticizing her,³⁴¹ and over charged the case and committed serious breaches of protocol (according to Jonathan Turley).³⁴² The real story, however, was the denunciation of the verdict. Nowhere in the cacophony of screams about the injustice did I discern any evidence of misconduct by the *jury*. It seemed like a potentially sympathetic group of well-meaning citizens. They listened to the case, deliberated for a time proportionate to the volume of testimony, and delivered the verdict. That, according to our system, is the correct result *by definition*. To denunciate the verdict is to denounce the system.

Chris Dorner, former LAPD policeman, seemed to be pushing his Constitutional rights into dangerous territory by repeatedly over a period of years alerting his superiors to rampant graft within the department. Peer pressures mounted, and Dorner snapped. He declared war against the authorities, killed a few people (as did the police³⁴⁴), and reputedly died in a fire. What's the Michael Lewis narrative in this one? First, he left a manifesto.³⁴⁵ I recommend you read it and ask whether he was nuts, a recluse, a classic whack job. Of considerable import, it is rumored that authorities used domestic surveillance drones to catch him.³⁴⁶

I detest drones—domestic or foreign. If some sovereign state was flying drones over my hometown and lobbing guided missiles through kitchen windows, I

hope I would have the cajones to oppose that foe using any means—an enemy combatant, a terrorist. Domestic drones also drive me nuts, and scare me at a visceral level. I do not even like those seemingly passive speed monitors; they are desensitizing us. I hate automated speeding tickets. How are you going to feel when you get a speeding ticket on some back road late at night with nobody in sight because you were digitally tracked? I do not want to be tracked by my cell phone or car GPS. I am willing to forfeit security for freedom of speech and movement. This level of surveillance is destructive and makes a mockery of our Constitution. It is also the beginning of something that could become virulent.

The Constitution forbids the domestic use of military troops. The easy workaround is that you militarize the police. Maybe it's just perception—smartphones catching it more often—but instances of unruly displays of force seem to be picking up. New Hampshire police bought armored cars to defend against “groups such as the Sovereign Citizens, Free Staters, and Occupy New Hampshire.”³⁴⁷ That would be us. We caught the Boston bombers. It was a heinous crime that showed us that some things you cannot defend against. I'm somewhat agnostic on this one, but they essentially put Boston under martial law; it's hard to defend against that too. If you cannot deliver security as promised, can we at least have our privacy back?

Mandatory drug tests in high school may seem good to some parents.³⁴⁸ But even minors are granted Constitutional protections against illegal search. Mandatory DNA swabs at traffic stops is an idea of dubious merit.³⁴⁹ A grocer was arrested for depositing too much cash.³⁵⁰ Cash is a civil liberty—a form of privacy—we should protect *ferociously* even if it is a rapidly depreciating asset. I do not care if drug lords use cash; they also use cars, condoms, and boats.

A kid sat in jail for months without trial for poor judgment about what you should post in jest on Facebook. Apparently, using LOL does not undo the speech crime. More than 7,700 people have been arrested protesting the absence of banker arrests.³⁵¹

As described in *The Fourth Estate* section below, the media's rights are getting trampled on, forcing reporters to take special precautions to protect their sources. Pissing off the media may have been a bad move for the totalitarians, although I believe that the media is already under a firm grip.

California passed a zero tolerance—*zero tolerance*—DUI law.³⁵² Do you know how many substances are considered intoxicants and how long they take to completely clear your system? You better figure that out before you drive to work tomorrow morning.

It appears that the DOJ investigated Standard and Poors for downgrading U.S. debt and not being owned by Warren Buffett.³⁵³ *That* is a heinous crime. Eminent domain of mortgages—said by some to be an illegal taking—is going to be used in Richmond.³⁵⁴ Contract law is optional when crony capitalism sees a pie to be divided. Some restaurants are requiring ID to use \$100 bills.³⁵⁵ If I knew of one, I would go there with only \$100 bills and no ID. Take it or leave folks: it's “legal

tender” you morons. Facial recognition software is being used in shopping malls to optimize your shopping pleasure, but to me it brings new meaning to Black Friday sales.³⁵⁶

The Supreme Court, a body of judges who draw scorn but remain in my wait-and-see box, repealed the Voting Rights Act of 1965.³⁵⁷ I am even less qualified to have an opinion on this one, but it smells odd. They also ruled that remaining silent can and will be used against you in a court of law unless you *properly* invoke your Fifth Amendment rights.³⁵⁸ The bad guys will figure out how to do this; honest people will go into an arrest ignorant of this technicality.

Apparently those wussy Guantanamo detainees didn’t like the waterboarding everyday, spurring them to try to take the final exit with hunger strikes. We force fed them because there was simply no other way to ensure that they rot in a cell without legal recourse.

Michael Lewis resurrected the Sergey Aleynikov case³⁵⁹ that I’ve summarized previously.⁴ Sergey did not invoke his Fifth Amendment rights because he thought he could clear up a misunderstanding when he was accused of stealing the Goldman Sachs software used to manipulate markets. He got 97 months in prison for a “theft” that profited him precisely \$0. The conviction was overturned by the United States Court of Appeals for the Second Circuit. No problem. They arrested him again from a different jurisdiction on different charges (the crime of pissing off Goldman), avoiding the constitutional prohibitions against double jeopardy. He was convicted.

Civil Liberties Part 2—Edward Snowden versus the National Security Agency

“I do not expect to see home again”

~Edward Snowden

With the aid of Glenn Greenwald of the *Guardian*, NSA analyst Edward Snowden stepped forward to denounce the agency’s spying tactics, obliterating any hope of his having a normal future.³⁶⁰ This could have easily been deemed a traitorous move and quickly shoved to page 17, but it simply wouldn’t go away: Snowden had the goods. He had the evidence. The story morphed into Hoover 2.0—privacy invasion on steroids.

Everybody (except the Amish) knows the Edward Snowden story. Many do not know it is an old story. The ghosts of the NSA past are haunting reminders that we knew it all along:

“America’s intelligence gathering...capability at any time could be turned around on the American people, and no American would have any privacy left. Such is the capability to monitor everything: telephone conversations, telegrams, it doesn’t matter. There would be no place to hide...I know the capacity that is there to make tyranny

total in America, and we must see to it that all agencies that possess this technology operate within the law and under proper supervision so that we never cross over that abyss. That is the abyss from which there is no return."

~ Frank Church, U.S. senator on *Meet The Press*, 1975

"A Federal Court of Appeals recently ruled that the largest and most secretive intelligence agency of the United States, the National Security Agency, may lawfully intercept the overseas communications of Americans even if it has no reason to believe they are engaged in illegal activities. The ruling, which also allows summaries of these conversations to be sent to the Federal Bureau of Investigation, significantly broadens the already generous authority of the NSA to keep track of American citizens."

David Burnham, *New York Times*, 1983

"No laws define the limits of the NSA's power. No Congressional committee subjects the agency's budget to a systematic, informed and skeptical review. With unknown billions of Federal dollars, the agency purchases the most sophisticated communications and computer equipment in the world. But truly to comprehend the growing reach of this formidable organization, it is necessary to recall once again how the computers that power the NSA are also gradually changing lives of Americans—the way they bank, obtain benefits from the Government, and communicate with family and friends. Every day, in almost every area of culture and commerce, systems and procedures are being adopted by private companies and organizations as well as by the nation's security leaders that make it easier for the NSA to dominate American society should it ever decide such action is necessary."

~*New York Times*, 1983

"All you need to know about so-called oversight is that the NSA was already in violation of the Patriot Act by the time it was signed into law."

~Thomas Drake, former senior executive of the NSA, 2005

"I don't have to listen to your phone calls to know what you're doing. If I know every single phone call you made, I'm able to determine every single person you talked to. I can get a pattern about your life that is very, very intrusive. . . . If it's true that 200 million Americans' phone calls were monitored—in terms of not listening to what they said, but to whom they spoke and who spoke to them—I don't know, the Congress should investigate this."

~Joe Biden, future vice president of the United States, 2006

“The KGB, the Stasi, and the Gestapo could never have dreamt of having anything that’s as great or comprehensive as this capacity to monitor the population and control it...that unfortunately is what our government is doing.”

William Binney, former NSA cryptomathematician, 2012

Is Edward Snowden a traitor or a patriot? It depends on who you ask:

“[Edward Snowden] has revealed evidence of what appears to be crimes against the Constitution of the United States”

~Al Gore, former vice president of the United States, 2013

“I don’t look at this as being a whistle-blower. I think it’s an act of treason.”

~Diane Feinstein, liberal democratic senator from California

“America has no functioning democracy at this moment...I think the invasion of privacy has gone too far...[Snowden’s insights are] likely to be useful because they have informed the public.”

~Jimmy Carter

“I must admit in my darker moments over the past several months, I’d also thought of nominating Mr. Snowden, but it was for a different list.”

~Michael Hayden, former Director of the NSA and CIA, implicitly referring to the presidential "kill list"

“It is the height of naiveté to think that, once collected, this information won’t be used”

~Wolfgang Schmidt, former Stasi agent

“I hope we follow Mr. Snowden to the ends of the earth to bring him to justice.”

~Lindsay Graham, U.S. Senator from South Carolina

“When the American people find out how their government has secretly interpreted the Patriot Act they will be stunned, and they will be angry.”

~Ron Wyden, U.S. Senator from Oregon and member of Senate Intelligence Committee

“NSA is one of the largest employers in my district, and it works every day to keep us safe.”

~Dutch Ruppersberger, U.S. representative from Maryland

“There has not been in American history a more important leak than Edward Snowden’s release of NSA material—and that definitely includes the Pentagon Papers 40 years ago”

~Daniel Ellsberg, analyst who released the Pentagon Papers

“To the extent that you have aided and abetted Snowden, even in his current movements, why shouldn’t you, Mr. Greenwald, be charged with a crime?”

~David Gregory, *Meet the Press*

Michael Hayden fessed up that the NSA did *not* disrupt 54 terror plots as claimed but rather “one, perhaps two”.³⁶¹ Director of National Intelligence, James Clapper, admitted to perjuring himself to Congress about NSA activities,³⁶² he was put in charge of the independent investigation into NSA spying.³⁶³

Every major tech company in the world appears to be under NSA control. The CEO of Yahoo, Melissa Mayer, slipped up by describing consequences: “If you don’t comply, it’s treason.”³⁶⁴ Facebook’s head of cybersecurity worked for the NSA.³⁶⁵ The CEO of Lavabit, an encrypted internet provider pressured to participate in NSA data collection, closed his business.³⁶⁶ Pending prosecutions suggest that shutting down the company was *not* one of his options. The participation of Verizon, AT&T, Microsoft, Yahoo, Google, Facebook, PalTalk, AOL, Skype, YouTube, and Apple rewarded with multi-million dollar compensations for their services makes it clear that *every* tech company has been infiltrated.³⁶⁷

So who did the NSA spy on? You, me, our emails, our cell phone calls, Angela Merkel, the participants at the Davos economic summits, the United Nations, spouses, girlfriends, anybody who uses a credit card..everybody doing everything. Politicians under surveillance included a young senator from Illinois who became president of the United States. It is not a bold extrapolation to presume that they are still spying on him.

So here’s where it gets really nasty. The NSA has been feeding information to local law enforcement agencies.³⁶⁸ NSA is also providing information necessary to cover up the illegality of the search and seizure that put the domestic police forces on the scent. “It sounds like they are phonying up investigations” said

Nancy Gertner, Harvard law professor and former federal judge.³⁶⁸ The DEA has been a favorite recipient of NSA-derived information.

All those dastardly folks defending the NSA may not be as evil as they sound. They may be very afraid or, at the very least, terminally spineless. What dirt do they have on Graham, Feinstein, Obama...? Grow a pair, folks. The ACLU is not spineless.³⁶⁹ One must assume that The ACLU's communications have been monitored since its formation back in 1920. Michael Hayden refers to the rest of us Snowden supporters as ““nihilists, anarchists, activists, LulzSec, Anonymous, twentysomethings who haven't talked to the opposite sex in five or six years”. I protest: I am not a "twenty-something”.

“What makes us different from other countries is not simply our ability to secure our nation. It's the way we do it, with open debate and democratic process.”

~Barack Obama

Mister President. Correct me if I am wrong—you are the constitutional lawyer by training—but I believe you are charged with defending the Constitution of the United States, and it is a treasonous and an impeachable offense not to do so.

Conclusions

“A witty saying proves nothing.”

~Voltaire

What are the lessons that I take home from surveying the financial and political landscape of 2013?

Markets. They look broken to me. Maybe I am simply grumpy from being on the wrong side of them this year, but it's not hard to make the case that state control of the money supply and explicit state control of the price discovery mechanisms elicit behavior that, although seemingly profitable at times, is likely to lead to lousy returns in the least going forward and, more likely, to an 80-car pile up in the fog produced by loose monetary policy. I sense that many investors know we are in trouble and are responding in a *National Lampoon*-esque way by throwing a Toga Party. Everybody—equity traders, bond traders, Forex traders—all seem to have one eye on the exit. It is a truism of markets, however, that the party cannot last and, by definition, the exits are not big enough for everybody to leave at once. There will be some serious bag holding. Will the *banking system* hold up to another body blow? I haven't a clue. I do know that the two painful years that I was completely on the wrong side of the market previously—1999–2001 holding gold and no equities—seemed interminable then and look like a blip now. Keep dancing at your peril.

Debt. I will say it one last time. *Austerity is not a policy; it is the result of bad policies.* We don't get to duck the consequences of our high-flying ways—spending more and saving less—any more than the alcoholic gets to regrow a liver. By every measure I can find, the debt is burdensome, generational, and coming at us like a force of nature. The entire world is run on a paygo system. We haven't stockpiled food, shelter, or any other consumable because we can't. What you can stockpile are chits, IOUs, promises from others to do the heavy lifting for you. As the boomers retire, they will find that their stash of chits cannot buy them goods and services from the Chinese because the Chinese hold chits of ours. Our kids can't readily provide all goods and services; we outnumber them. I believe that unfunded liabilities, promises made that were not cashed in at the time, represent latent inflation pressures. The cashing in of these IOUs—large numbers of chits chasing limited goods and services—could trigger a virulent inflation. In this paygo system, we flourished while the boomers produced and were compensated with promises. Now we are about to hit the downslope.

Civil Liberties. If you've made it this far, I imagine you are a little nervous about the future. Our civil liberties are under attack by a growing and increasingly onerous state armed with invasive technology. It might not even be some master plan. Which locust destroyed the field? Which snowflake caused the avalanche? Government is a living, breathing organism that evolves but is not always benign. George Orwell is looking prophetic. We should defend ourselves while we can, although I am worried that we are way behind. As you hear some numbnut wax euphorically over facial recognition software in the grocery store, extrapolate beyond the snack food aisle. We should defend every civil liberty, no matter how trivial it may seem. Hope is not a strategy.

I certainly did not expect to get this gloomy. To bring some balance, read a few listicles describing "deathbed regrets".³⁷⁰ You will find that the dying make no mention of bonds, stocks, Bitcoin, or even gold. Their regrets and reflections are more primal. And with that, I finish with a list of books I read this year.

"This too shall pass."

~Somewhere in the Bible

Books

"I cannot remember the books I've read any more than the meals I have eaten; even so, they have made me."

~Ralph Waldo Emerson

The Battle of Bretton Woods: John Maynard Keynes, Harry Dexter White, and the Making of a New World Order by Benn Steil

In 2012 I gave a heads up on this book pre-publication. It is now in print and starting to accrue some serious accolades. Steil has an Austrian economic slant

and is a fellow at the Council on Foreign Relations (CFR). He describes a fascinating battle between Harry Dexter White and John Maynard Keynes before, during, and after the 1944 Bretton Woods Conference in which the future world currency regime was hammered out. We get deeply insider views of the events in a prose and presentation that I found gripping. Keynes's role as a diplomat, unknown to many, may have been his most important single contribution. Heads up: Steve Hanke of the Cato Institute and Johns Hopkins University also has a book on the Bretton Woods Conference coming.

Setting Sun: The End of U.S. Economic Dominance by Brandon Adams

Brandon's book is only 100 pages of book. He wanders through arguments that suggest that the U.S. is headed for tough times going forward, culminating in a painful deleveraging that is likely to last for many years (decades). What started out as a pleasant synopsis of what I thought I already knew proved to be a great read. The prose, citations, and arguments are all sound. Brandon tells an excellent tale even for a connoisseur of fine doomsday books. It is clear that he did not just pound this out but rather let it evolve—he let it come to him. I am envious.

The Great Deformation: The Corruption of Capitalism in America by David A. Stockman

This is Stockman at his most militant. The book starts with him pounding on the crooks and liars. It is six hundred plus pages of relentless pounding—a gigantic blog. I thought it was great, but I don't think he will convince non-believers. He is *way* too pissed off, and if they haven't gotten it by now only another crisis will bring the point home. For us believers, it is a great overview with some really great insider wisdom from his days in private equity. T-shirt idea: "I finished the Great Deformation" (to be sold by Snorg-Tees, of course.)

The Panic of 1907: Lessons Learned from the Market's Perfect Storm by Robert F. Bruner and Sean D. Carr

This was an easy and entertaining read. One gets a real sense of what a bank run feels like. A leveraged speculator in community banks goes insolvent, starts a run at his primary creditor, and next thing you know you have panic spreading through the New York banking system and eventually the nation. Many of the stories you may have heard in snippets throughout the blogosphere. It was a nice compilation of the narrative in one place. The descriptions of what was going on in back rooms and at the teller windows was very entertaining.

The Thomas Sowell Reader by Thomas Sowell

For Thomas Sowell fans, this is a treasure trove of brilliant essays on all imaginable topics written throughout the author's life. He challenges volumes of dogma coming from the intelligentsia, a term of scorn used by Sowell repeatedly, especially the intelligentsia's proclivity for rescuing the masses from self-inflicted wounds. It is clear that Sowell dismisses the end result of their efforts as

disastrous and questions their motives. Those willing to entertain his ideas with an open mind will be challenged, provoked, and impressed. Some will find his ideas intolerable.

The Big Con: The True Story of How Washington Got Hoodwinked and Hijacked by Crackpot Economics by Jonathan Chait (2008)

I've had time to reflect on the G.W. Bush presidency and the ascendancy of republican economic policies. Over the last decade I must have read a dozen Bush bashing books starting with Paul O'Neill's. By the time Bush's presidency was over, there was a lot to be upset with. This book, however, did not age well. It is way too partisan.

The Map and the Territory: Risk, Human Nature, and the Future of Forecasting by Alan Greenspan

There is no way I spent one penny or consumed one molecule of ATP reading this narcissistic egomaniac's book. Now he's doddering on the brink of cluelessness. I put it here to see if you are paying attention.

The No Asshole Rule: Building a Civilized Workplace and Surviving One That Isn't by Robert I. Sutton

This is a humorous little book describes the role of assholes in the workplace. It was entertaining. The key message is that someone who is truly an asshole is not worth keeping around no matter what other talents they seem to possess.

Made to Stick: Why Some Ideas Survive and Others Die by Chip Heath and Dan Heath

The Heath brothers bring complementary skills to put together a treatise on why some ideas stick and others do not. The book was described to me as a game changer—Moneyball 2.0. I found it excellent and well worth the read. I am a sucker for this kind of Gladwellian tale. The money shot: tell a narrative.

Dirty Wars: The World Is A Battlefield by Jeremy Scahill

Scahill is a left-wing, anti-war journalist of considerable repute. He describes the evolution of the modern war in which small armed forces can attack sites around the world. It is a history of the modern U.S. war machine. He is no fan of the right, but Obama takes a serious beating. Scahill describes him as more militaristic than Bush by essentially every measure. It's a good, although unpleasant, read.

This Town: Two Parties and a Funeral-Plus, Plenty of Valet Parking!-in America's Gilded Capital by Mark Leibovich

The author is an insider describing the world of Sodom and Gomorrah that we call Washington DC. It's good, although not quite what I hoped. Leibovich

describes in lurid detail selfish, craven behavior that is so bad that there is little wonder the politicians never achieve anything. It complements Peter Schweitzer's *Throw Them All Out*.

1491: New Revelations of the Americas Before Columbus by Charles C. Mann

I've tried to grapple with pre-Columbian history on several occasions, and it simply does not click for me. This one didn't either. I imagine others might disagree. The strange names and details that I didn't seem to care about, and efforts to sell the civilizations of Mesoamerica as comparable to any in Europe, fell flat. Try the slightly later post-Columbian history by reading *Mayflower*.

The First Human: The Race to Discover Our Earliest Ancestors by Ann Gibbons

The author—*Gibbons? Really?*—describes the race to push human remains back further into the past. We now have human fossil records dating back 8 million years. This is less a tale of human evolution and more a tale of whacky anthropologists battling for turf, prestige, and the good graces of the National Geographic Society. It is a window into their world in which the fights are so venomous because the stakes are so small.

Dark Sun: The Making of the Hydrogen Bomb by Richard Rhodes

Rhodes describes the making of the thermonuclear hydrogen bomb (not the atomic bomb). It has some physics in it, but it is an easy and riveting read about the Cold War era. Funny story: 20 years ago I was in the faculty lounge at Cornell, suggesting that mutually assured destruction (MAD), as dangerous as it is, has worked so far. A cranky old guy sitting right behind me decided to take issue with that view. It was Hans Bethe.

Cronkite by Douglas Brinkley

Many of us grew up watching Walter Cronkite (thinking he was Walt Disney). This is a story of his (Cronkite's!) career, the evolution of broadcast news, and events that shaped boomers lives. Cronkite was a very intense guy, not what we saw on TV. Familiar names like Smith, Safer, Murrow, Rooney, Huntley, Brinkley, and Walters come to life. Dan Rather, on the other hand, comes off as an unflattering body part.

Why We Get Fat by Gary Taubes

Taubes puts forth essentially the message of the Atkins diet; carbs kill, especially the ones you don't see (high fructose corn syrup.) He really nails it when he rephrases the title question, "what influences fat deposition?" He does an amazing job of dealing with the seeming truism that calories in-calories out is the only rational model. For the record, cutting carbs is *very* hard to sustain.

Acknowledgements

Last year I named the many who have contributed to this interesting journey through the financial markets. This year I wish to draw attention to the guy who taught me the most about business, inflation, deflation, distressed assets, and the miracles of capitalism—a CEO who created some serious wealth:

Edward B. Collum 11/20/27 – 08/01/13 Thanks Dad

Links

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