The Long & Short of It
Quarterly Newsletter
First Quarter 2021

The Long & Short of It is now in its 24th year of publication. Its purpose is not to evaluate individual investment ideas, but rather the macro environment in which they might take place. We are very grateful for our readers' patience and interest.

Shifting Priorities
The most important macro variables have changed and condensed significantly over the years. Recent editions of *The Long & Short of It* have focused on government spending and monetary policy. Prior issues examined inventory levels, demographics, productivity, trade, supply, and so on—all very important influences in an environment of recurring business cycles. However, in today's age of muted business cycles, these topics have less influence. Of greater impact are the activities of government. Government spending now comprises over 45% of all economic activity, up from 8% in 1900 and 32% in 2000. While fiscal policy redistributes monies from one bucket to another and thereby determines economic winners and losers, monetary policy also plays an underestimated but increasingly important role. It is the tail that wags the proverbial dog and, as such, we devote many of these pages to it.

From a broad historical context, monetary policy deals with interest rates and credit, which are fundamental to human existence. Food, shelter, and our very survival rely on credit, as does common civility. John Maynard Keynes connected the dots between inflation and debt in *The Economic Consequences of Peace*:

> *As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.*

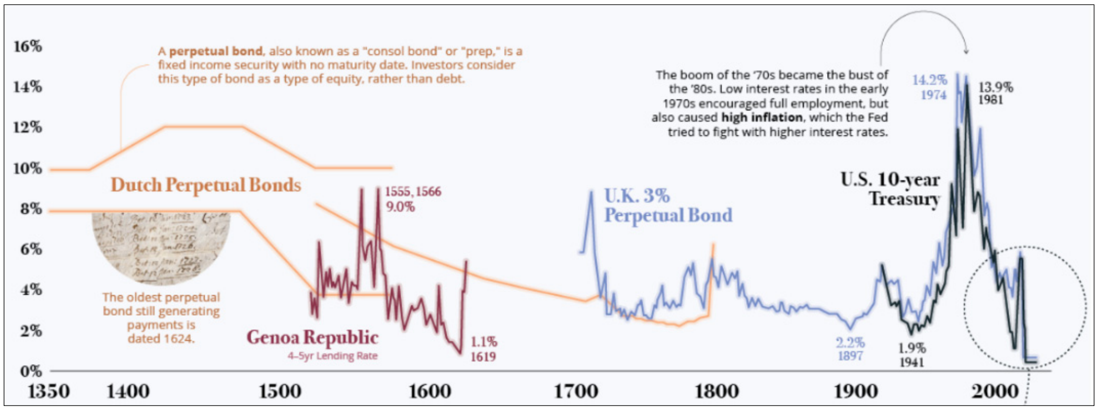
We would take this a step further and say that not only do "all permanent relations between debtors and creditors…form the ultimate foundation of capitalism," they also comprise the foundation of civilization itself.

Contracts and Time Preference
Early humankind progressed from "eat only what you kill while it's fresh" to "have some of my excess in exchange for some of yours later," giving rise to the concepts of contract and time preference. Delay involves both deferring enjoyment and embracing risk, but contributing one's excess to others today in return for something later when you may not have so much is vital to progress. Now is truly better than later. If you have ever been hunting, you know that a bird in the hand is actually worth something like two in the bush. So, it makes sense that some form of compensation would be developed to account for time preferences (i.e., interest, or the price of credit).

In other words, the agreement/contract between debtor and creditor forms the foundation of trade on which humanity's very existence relies. Without rational mechanisms and pricing for trading goods, services, and time, we can neither feed, shelter, nor clothe ourselves effectively. A government's job is to promote stability, fairness, and even some innovation in these contracts and pricings between debtors and creditors. When government artificially corrupts these contracts or prices by forgiving some borrowers and not others or controlling prices, a functioning economy—and potentially civilization—can break down.

History is replete with examples of governments and kings presiding over the violation of contracts, manipulating prices, and handing out currency to loyalists to help the regime in power. It often does not end well. Here in the US, many of our founding principles keep monetary control and rulemaking dispersed and local to minimize the temptations faced by a centralized governing class.

Interest Rates So Low…



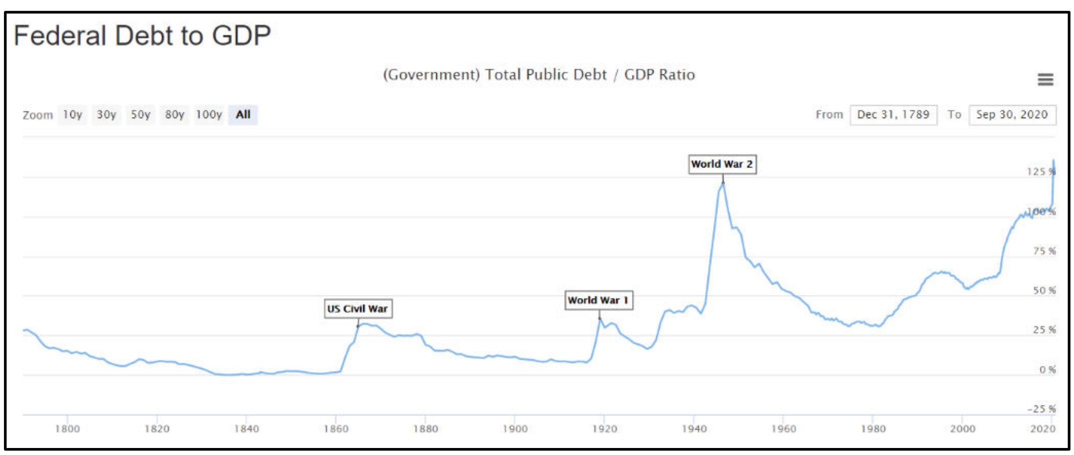
Source: visualcapitalist.com, Sidney Homer and Richard Sylla - A History of Interest Rates

Low overnight interest rates set by the Federal Reserve encourage borrowing and economic growth, while high rates suppress growth and slow the economy. However, artificially low interest rates, especially across all maturities on the yield curve, induce people, companies, and governments "to lay on debt, chase yield and misallocate capital," as described by Jim Grant. The resulting bubbles and bad decisions will hinder economic progress. Most booms and busts throughout history have been caused by mispricing of credit.

But with all the regulations on lending, in this age of supercomputers and the information revolution, wouldn't the Federal Reserve have enough tools and data to make sure credit is priced properly? The problem lies not with the regulations but in their implementation. Today, the Fed seems to invent new rules for monetary policy on the fly. Moreover, the tools used to measure the effectiveness of monetary policy and the health of the economy are not perfectly calibrated. While the Fed's mandate includes the admirable goals of controlling inflation and reducing unemployment, it does not include optimizing real GDP per capita.

In addition, the Fed's core inflation measure does not include "savings assets" items like housing and investments (only rents on housing are included). Inflation would have been measured differently at times if these and other asset prices were included. Some academics speculate that if real estate had been incorporated into core inflation in the 2000s, then the 2008 housing bubble and crash and subsequent Great Recession might not have occurred because the Fed would have raised rates earlier.

…They Keep the Peace



Source: longtermtrends.net

Today, the Fed has become a de facto arm of the US Treasury as the buyer of last resort for US Treasuries. The Treasury issues debt and rolls over maturing obligations and the Fed purchases much of the issuance because the primary dealers (non-government institutions that purchase newly issued US Treasuries on the open market) cannot soak up all the supply. "[T]he seven-year [Treasury] auction size is 220% from where it was in 2018...from $28 billion a month to $62 billion a month. We've doubled the flood and halved the size of the bucket to bail it with," observed Capital Group's Ryan Hall.

Consequently, the laws of supply and demand are no longer in control of the price of money; the Fed is. Not enough buyers would normally mean the price of a good would rise, i.e., bond prices would fall and markets would notice the problem. However, with the Fed buying up the Treasury issuance that the market cannot absorb, bond prices stay high and interest rates remain at historic lows.

The Fed's controlling of interest rates may continue until, as Keynes explains, "we debauch the currency." In 2020 the Fed demonstrated they were willing to go from purchasing short-term Treasuries to buying corporate bonds and Exchange Traded Funds in order to maintain the picture of normalcy during the heart of the pandemic panic. But these purchases enabled the Treasury to issue more debt and further obfuscate the market's vulnerability. The Fed has stopped these programs for now but as the debt problem grows, we have no doubt the programs will resume. Price controls on interest rates are spreading.

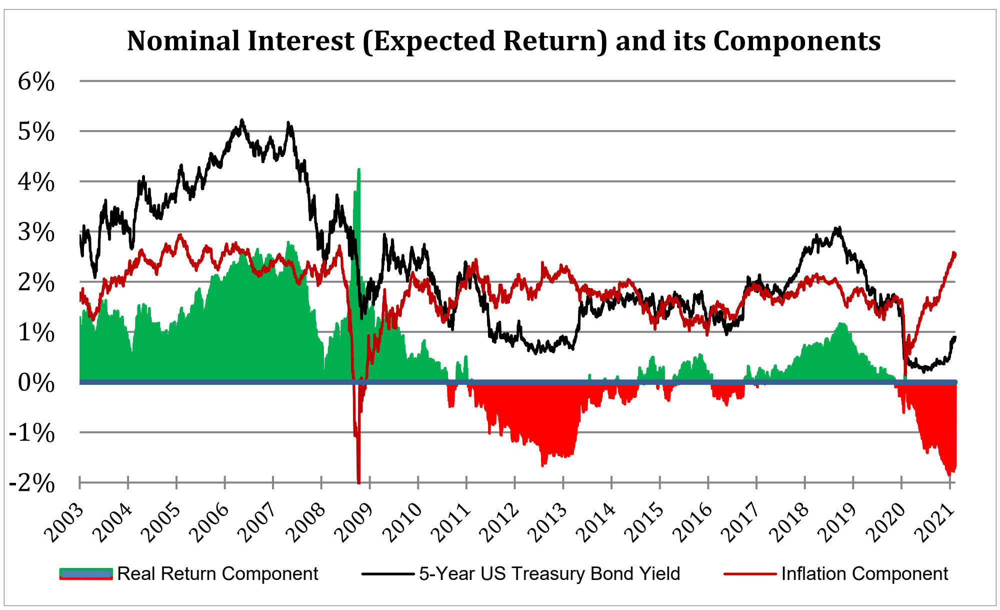
Controlling the price of credit reminds us of how controls on the price of gasoline failed in the 1970s. As recounted in the June 7, 2007 issue of the *Chicago Tribune* by Jack Rafuse, former energy adviser to the Nixon administration:

> President Richard M. Nixon imposed wage and price controls on Aug. 15, 1971. Oil and gas were two of many commodities affected. An initial 90-day freeze turned into more than 1,000 days before the controls were dismantled. Inflation—just above 4 percent in 1971—was in double digits when the controls were lifted.
>
> Nixon kept the wage-and-price controls on oil, gasoline and petroleum products in place, as did Presidents Gerald Ford and Jimmy Carter. The results were disastrous. Oil exploration and domestic oil production slowed sharply. And foreign oil poured into the nation's gas tanks, filling the booming demand for price-controlled gas.
>
> Thanks to this misguided policy, gasoline lines snaked along highways for hours during oil crises in the mid- and late-1970s. Stations ran out of gasoline and laws told consumers which days they could purchase gas.

A similar drama is unfolding with US interest rates. Too many are lining up to fill their tanks with unrealistically cheap debt, especially the federal government, which uses the proceeds to keep debt cheap and the game in play. No one knows when the music will stop and interest rates be allowed to float freely.

Conflict of Interest

Today's federal government no longer serves the people. It serves itself. The destruction of the interest rate mechanism by keeping rates artificially low encourages the piling on of debt, which serves neither the American taxpayers nor their children who will be left with the bill. To paraphrase Oscar Wilde, "The bureaucracy expands to meet the needs of the expanding bureaucracy."



Source: Federal Reserve, US Treasury

The cost to service the federal debt will eventually rise alongside interest rates. With each 1% rise in the rate paid on Treasuries outstanding, the interest payment on the national debt increases by roughly $280 billion, approximately 20% of all discretionary spending in the federal budget. For perspective, $280 billion funds NASA ($25B), Homeland Security ($50B), the department of Veterans Affairs ($105B), and Health and Human

Services ($96B). Can you imagine the government allowing rates to rise and cut off their primary source of growth? Of course not. They will instead seek to devalue the currency through greater inflation while keeping nominal interest rates low. The only thing left is the only thing that really matters: the real return on a dollar.

Keynes, again, sounded the alarm:

> *By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and while the process impoverishes many, it actually enriches some…*

Understating inflation means the Fed can engage in more expansive monetary policy, blowing more asset bubbles, which sadly hurts the poor more than the rich by adding to wealth inequality. Businesses and investors will make bad capital allocation decisions based on faulty inflation and market pricing signals, thereby damaging real economic growth further. The game of musical chairs goes on. Over time, the speculations will ebb and flow violently while real assets and the means of production will continue to steadily hold their value.

With economic growth and interest rates managed down by the government, borrowing is excessive and neither political party really wants to fix it. The government being primarily a borrower is a warning: "Creditors, beware." The District of Confiscation now serves its own bureaucratic needs more than its citizens or future generations and the pace of the abuse progresses. To quote the new White House National Economic Council Director, "the risk of doing too little outweighs the risk of doing too much. … (G)overnment must be a powerful force for good in the lives of Americans." It is a familiar refrain from government officials and a noble goal, but it would be best attempted without yield curve controls, especially when used for excessive debt issuance.

Ironically for individuals, the old "flight to safety" maneuver of putting one's cash under the mattress is likely the precisely wrong move today, as it would be a bet of confidence in the US dollar and our government's fiscal prudence. The game of musical chairs is trickier than it seems. At Robinson Value Management, we attempt to study the game diligently, stay nimble, and take reasonable but prudent risks. Our goal is to help client portfolios increase purchasing power using purposeful diversification. In the end, portfolios must maintain their balance through any environment and sustain investors into the next market cycle.

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