

How Gullible Are We?

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On my desk is a book titled *Fed Up*.

The book is an insider's take on why the Federal Reserve is bad for the US.

The title also describes my current mood...I'm fed up with our failure to learn from history.

What compels us to keep repeating the same mistakes over and over again?

If it was a child continuously falling into trouble, our frustrated response would be: When will you ever learn? Or, as some teachers in a bygone era used to say, 'What does it take to get it through that thick skull of yours?'

Yet, [as investors](#), the lessons of markets — booms and busts — are ignored each and every time a market is in hot pursuit of record levels.

The laws of mathematics are temporarily suspended while we indulge in these flights of fancy...hoping, wishing, praying and, in some cases, believing this time is truly different from the past.

It never is.

And the really cruel twist is that the longer a market avoids its fate with destiny, the greater the number of people who start to entertain the tantalising prospect of it being a 'new paradigm'.

Unless human nature changes, we are perpetually doomed to learn the hard way.

Over the centuries, we've made huge advancements by learning from the mistakes of our predecessors. The rapid progress in technology, medical science, space travel and healthcare is all thanks to our willingness to learn and evolve.

Ironically, though, when it comes to markets and the economy, we are still as naïve and stupid as the tulip-buyers of 400 years ago.

We think we are smarter, but our actions prove otherwise.

History tells us emphatically that debt crises always — without exception — end badly.

Debts are defaulted on. Businesses go bankrupt. Creditors lose money.

That's how debt is expunged from the system...very, very painfully.

Based on the laws of 'yin and yang', the more debt that's in the system, the more painful the process of expunging it becomes. It's not rocket science to comprehend the process which says that, the higher you climb, the harder you fall.

Here we are sitting atop THE greatest debt pile in history — US\$60 trillion more than we had in 2008 — and such is our misplaced mindset that we expect to add even more debt to this pile, without the slightest risk of triggering an avalanche.

Seriously, how stupid are we?

In response to NAB raising its home loan rates last week by 0.25%, Prime Minister Malcolm Turnbull, with a mix of ire and indignation, said: '*If they don't explain it then NAB customers will go somewhere else and I'd encourage them to do so.*'

Give me a break. It was only 0.25%.

Where was this anger when savers had to endure the RBA slashing rates from 7% in September 2008 to 1.5% today? This was effectively a pay cut of nearly 80% over an eight-year period.

There was no ire and indignation emanating from Canberra over the fate suffered by savers.

In Aussie colloquialism, they didn't care 'two knobs of billy goat poop' about savers...it was all about borrowers.

Why?

Because the entire economic growth model is completely and utterly dependent upon more and more debt being shoved into the system.

A miniscule 0.25% rise — the equivalent of a matchstick splinter in the finger — is treated as if the patient is in need of trauma counselling.

This is all part of the namby-pamby world we've created, where every kid gets a prize.

[The central banks](#) (the RBA, the Fed, the BoJ, the ECB, et al), together with their political masters, have, since 2008, engineered an economic 'recovery' based solely on the creation of more debt.

Since 2009, global GDP has risen from US\$60 trillion to US\$75 trillion. Over the past seven years, it's taken US\$60 trillion of debt to generate US\$15 trillion in economic activity...\$4 of debt to \$1 of economic output.

What we've seen since 2009 is the illusion of growth.

The question I have for all those cheerleaders who see US growth picking up is: What if we could magically stop all further borrowing today; what do you think the 'growth' number would be?

The response would be: 'You can't do that; the system needs debt to function.'

The also needs food to function, but we know too much food creates obesity, resulting in major health issues and organ failure.

So, my second question is: How much debt is too much debt before you think the system is at risk of major organ failure?

Obviously, they do not think you can have too much debt. But, as data shows, the more debt the system has around its girth, the more sluggish it becomes. Currently, it takes around \$4–5 to generate \$1 of economic output. If the expanding debt girth continues, it's going to take \$8–10 to move the GDP needle. Clearly, we have a situation that is not sustainable.

The very toxin that created the 2008/09 crisis is supposedly meant to cure us this time...apparently, this time must be different.

If people are naïve, gullible, or just plain ignorant to the fact that you cannot solve a problem using the same solution, then, in the years a, they are going to learn that lesson the hard way.

Siding with history

On the theme of illusion and delusion — and blindsiding investors — in [last Friday's Daily Reckoning](#), I wrote about the divergence in opinion between those that accurately identified previous bubbles and those that failed to see the disaster a of time.

Here's a short extract:

'...never let the truth get in the way of a good story. And, for the investment industry, there's no better story to tell than a market that's been on the up and up for an extended period. This gives them past performance to sell and extrapolate...

'...[Robert Shiller and John Hussman] missed a 250 per cent rise in the S&P 500 since the global financial crisis...

'...that's true. But those gains are only lasting if you take Professor Shiller's advice and reduce exposure to the market. Otherwise those gains are only on paper.

'What happens if, once again, Shiller and Hussman are correct and we have another bubble that's about to burst?

'The two previous bubbles have wiped out 50% in market value. This bubble appears to be even bigger than its predecessors; therefore, a 60% fall is not out of the question, or without precedent.

'A fall of that magnitude would take the Dow back to 8000 points...wiping out all gains made since April 2009. The paper gains are shredded.'

[Investment industry experts](#), in the main, are perennial optimists...markets are never going to experience a major downturn. We know from recent history that this is most definitely not the case.

Once again, the industry 'go-to' experts are out there pacifying the passengers, soothingly reassuring them that 'there might be a slight swell a, but there's nothing to worry about.'

Yet those who have accurately read the market weather-charts in the past are warning investors that we are sailing directly into the perfect storm...*abandon ship*.

A cruise liner without any passengers is not a profitable business; the same goes for a funds management industry without any funds to manage. The message is: Keep the passengers on board...

In addition to Shiller and Hussman sounding the market storm warning, *The Wall Street Journal* (WSJ) recently ran with this line: 'Magic Eludes Bubble-Caller Jeremy Grantham, as Assets at GMO Drop by More Than \$40 Billion'.

Jeremy Grantham, of GMO (Grantham, Mayo, & van Otterloo), is one of the sharpest investment minds in the business.

I remember Grantham and Warren Buffett both shaking their heads in disbelief at the dotcom bubble. They were ridiculed for being out of touch with the new world. Not investing in tech stocks cost GMO dearly in short-term performance, and there was an exodus of money out of the firm's funds.

Grantham's reading of the market, and his discipline, was proved correct.

This is from the same *WSJ* article:

'In November [2016], Mr. Inker [co- of GMO's asset allocation team] wrote to clients that "almost all asset classes are priced at valuations that seem to guarantee returns lower than history." Mr. Inker added that "from today's valuation levels, there are no good outcomes for investors."

'Grantham "has been out of step with the market several times during the firm's four decades. GMO has usually rebounded, with the 78-year-old investor earning acclaim with asset-bubble calls as of Wall Street busts in 2000 and 2008."

'[GMO is] "Bearish about what it sees as high valuations of U.S. stocks, GMO's flagship mutual fund, the GMO Benchmark Free Allocation fund, has largely missed out on the latest rally in U.S. stock indexes."

Jeremy Grantham is 78 years old...he knows history. He's 'been there' and 'done that' since the 1970s. I've followed his newsletters for years. He's seriously smart and thoughtful.

GMO analyses risk versus reward across various asset classes based on the simple principle of 'reversion to the mean' — where nothing stays high or low forever.

However, the investment industry would like us to believe markets can remain in a state of suspended animation indefinitely.

When I read that investors had withdrawn US\$40 billion from GMO, it was a case of déjà vu. I've seen this pattern before.

Investors are their own worst enemy... Chasing returns, they want all the gains on the way to the top, with none of the losses.

The rare breed of fund manager that takes defensive action before a market crash is usually out the market well a of time. Performance suffers, and investors looking for a short-term buck rush to the latest star performer...the one that is 'all in' and which only ever sees a ripple on the horizon.

This is a familiar pattern.

Reading about Grantham, Shiller and Hussman's judgement being questioned *again* provides me with a lot of reassurance.

If history is a guide, we must be getting awfully close — possibly within months — to the US market collapsing in spectacular fashion.

Investors continually make the same errors of judgement...they deserve to get mauled for being so damn greedy and not heeding the signs.

Regards,

Vern Gowdie,
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