Cavelti

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To: Our Clients
From: Peter Cavelti

Countdown to Lift-Off

Dear Client:

The second quarter of the year was dominated by talk of the Fed's intended "lift-off" from a long period of near-zero interest rates and the Greek fiasco. Far too much has been written on these topics, which can easily be reduced to their essence.

In regard to "lift-off", let me say that I view the term used by the Fed, and quickly embraced by economists and the media, as a serious misnomer. I believe the Federal Reserve and its key counterparts abroad (specifically the European Central Bank, the Bank of Japan, the Bank of China, the Swiss National Bank and the Bank of England) all understand that any meaningful raise in interest rates would quickly nuke any chance of economic recovery and, concurrently, render their export economy impotent. Which leads me to fervently believe that we may get no interest rate increases at all, or, at most, one or two raises of ¼%. If anything merits multi-page essays, it should be the intellectual and moral failure of what has become the largest monetary experiment ever, not the week or month in which some minuscule rate adjustments will be made.

John von Neumann, the mathematician who invented modern game theory said in the 1950s, "There is no sense in being precise when you don't know what you're talking about." I believe it is now becoming increasingly apparent that something as complex as the economy cannot simply be addressed with the type of mathematical models used by the academics who run our central banks. Intriguingly, they end up doing exactly what von Neumann referred to: they're trying to be precise when they can't possibly understand the context. What is the right approach then? In my view, common sense would serve us better. Specifically, the kind of common sense that people like Benjamin Franklin espoused: being productive and thrifty will bring security and bliss, while being reckless and incurring excessive debt will ruin you. While Franklin was a man of talent, if not genius, this kind of advice did not take extraordinary intellect to invoke—rather, it was a reflection of a natural order that served humanity well, through many centuries and in numerous cultural environments.

The showdown between various power structures and Greece has provided journalists with equally spectacular content. Yet, here too, few commentators have reported little of substance; the root cause of the problem is barely ever addressed. To be sure, Greece has lived precariously (as have France, Italy, Spain, Portugal, Ireland and a few other nations), but this was made possible only because the IMF, the EU and the global speculative community flooded Athens with gifts of debt and subsidies so lavish it boggles the mind. What will be interesting about the outcome of the Greek saga are two things: whether International Monetary Fund will change its ill-conceived lending practices, and whether the EU and ECB will acknowledge that a currency union without a fiscal union is invariably doomed. I suspect the answer on both counts will be no.

Central Bank Easing in 2015

Count	Country	Date	Easing Measure
1	Romania	7-Jan	25 bps cut to 2.5%
2	India	15-Jan	25 bps cut to 7.75%
3	Switzerland	15-Jan	50 bps cut to -0.75%
4	Egypt	15-Jan	50 bps cut to 8.75%
5	Peru	15-Jan	25 bps cut to 3.25%
6	Denmark	19-Jan	15 bps cut to 0.05%
7	Turkey	20-Jan	50 bps cut to 7.75%
8	Canada	21-Jan	25 bps cut to 0.75%
9	Eurozone	22-Jan	QE (1.1 trillion Euros)
10	Pakistan	24-Jan	100 bps cut to 8.5%
11	Albania	28-Jan	25 bps cut to 2.00%
12	Russia	30-Jan	200 bps cut to 15.0%
13	Australia	3-Feb	25 bps cut to 2.25%
14	Romania	4-Feb	25 bps cut to 2.25%
15	Sweden	12-Feb	10 bps cut to -0.1%, QE
16	Indonesia	17-Feb	25 bps cut to 7.5%
17	Israel	23-Feb	15 bps cut to 0.1%
18	Turkey	24-Feb	25 bps cut to 7.5%
19	China	28-Feb	25 bps cut to 5.35%
20	India	4-Mar	25 bps cut to 7.5%
21	Poland	4-Mar	50 bps cut to 1.5%
22	Thailand	11-Mar	25 bps cut to 1.75%
23	South Korea	12-Mar	25 bps cut to 1.75%
24	Serbia	12-Mar	50 bps cut to 7.5%
25	Russia	13-Mar	100 bps cut to 14.0%
26	Sweden	18-Mar	15 bps cut to -0.25%
27	Pakistan	21-Mar	50 bps cut to 8.0%
28	Hungary	24-Mar	15 bps cut to 1.95%
29	Romania	31-Mar	25 bps cut to 2.00%
30	Serbia	9-Apr	50 bps cut to 7.00%
31	Sri Lanka	15-Apr	50 bps cut to 6.00%
32	Hungary	21-Apr	15 bps cut to 1.80%
33	Thailand	29-Apr	25 bps cut to 1.50%
34	Russia	30-Apr	150 bps cut to 12.50%
35	Australia	5-May	25 bps cut to 2.00%
36	Romania	6-May	25 bps cut to 1.75%
37	China	10-May	25 bps cut to 5.1%
38	Serbia	11-May	50 bps cut to 6.5%
39	Pakistan	23-May	100 bps cut to 7.00%
40	Hungary	26-May	15 bps cut to 1.65%
41	India	2-Jun	25 bps cut to 7.25%
42	New Zealand	11-Jun	25 bps cut to 3.25%
43	South Korea	11-Jun	25 bps cut to 1.50%
44	Serbia	11-Jun	50 bps cut to 6.00%
45	Russia	15 Jun	100 bps cut to 11.50%

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How will these developments affect financial assets? Unfortunately, there are no easy answers. So far, global central bank largesse has mostly favored stock and bond investments—at least in those mainstream economies that look good relative to their less fortunate peers. The table on the left, which records rate cuts administered around the world so far this year, gives you an impression of just how intense the race to zero and into negative interest rate territory is.

The question on everyone's mind is how long this trend can continue. Most reasonable people looking at this issue understand that the policies pursued in recent years will have highly negative consequences. Saving, in this new world, is rewardless and in some countries even penalized, while consumption and speculation are incentivized. A social order that has served humanity well for centuries has been replaced by something that is, by any definition, flawed and untenable.

What makes the situation even worse is that the demographic profile in numerous mainstream economies is rapidly deteriorating. In much of Europe and, even more so Japan, seriously impoverished pensioners, many of whom have led productive and prudent lives, will proliferate. Concurrently, as the older segment of society consumes less, unemployment among the young will rise.

The question on everyone's mind is *when* a "riot point" will arrive and *what form* it will take. Will it come in the form of social unrest, a policy error by a key central bank or government, a foreign military adventure gone wrong, a banking crisis, or will the catalyst be something entirely unforeseeable? No one can know, but it seems clear that the default force of the American-run world, organized money, is no longer serving us well. Unfortunately, the transition to a different system will most likely be messy and inconvenient.

In the meantime, stocks continue to hold their ground, especially in the United States, which to the Europeans, the Japanese and the citizens of many an emerging economy looks like an oasis of calm. Despite extremely high margin debt, rich valuations, a dollar high enough to seriously impair export earnings and abundant technical warning signs, for now international capital flows continue to favor the U.S. But, having said that, monetary history demonstrates that markets always revert to their mean—and the mean is at this time considerably below current levels.

With kind regards,