Gordon T Long
Global-Macro Tipping Points

www.GordonTLong.com
Market Research & Analysis

MACRO INSIGHTS

12 WAYS QE IS DESTROYING CAPITALISM

Sustained QE, ZIRP & Negative Interest Rates are Poison to Effective Working CAPITALism

Gordon T Long
9/16/2014

12 WAYS QE IS DESTROYING CAPITALISM

Sustained QE, ZIRP & Negative Interest Rates are Poison to Effective Working CAPITALism

United States & China
GDP Breakdown 2009

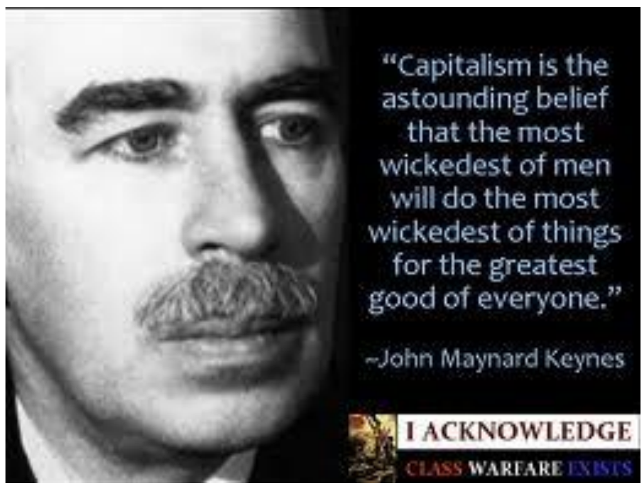
		United States	China
Personal Consumption Expenditure		71%	35%
Gross Fixed Capital Formation		16%	45%
Net Exports		-3%	4%
Government Spending	Now 20-24%	17%	13%

12 WAYS "QE" IS QUICKLY DESTROYING CAPITALISM

Nothing seems to stir emotion more quickly than the word "Capitalism". It seems it means a lot of things to different people depending on their overall belief systems.

What we need to focus on is that the core tenet of Capitalism is that Savings in the form of Profits is re-invested into productive assets. That is what Capitalism is.

There is nothing wrong with that and a matter of fact everything right about it!



Unfortunately this is not what is happening today.

1-Savings in the form of Profits is Re-Invested Into Productive Assets

Profits are not being reinvested into productive assets! They are being used in all manner of Financial Engineering.

When Dell Inc. spends more on buybacks than they earned over their entire lifetime then it is hard to see how earnings are being used to invest in productive assets that will create jobs and strengthen the economy?

As I have discussed in other presentations and papers the S&P 500 corporations will spend nearly $1 Trillion on Buybacks between 2013 and 2014. This is a distortion of unprecedented magnitude as a direct result of interest rates being so low that borrowing tax deductible money to reduce share count is less expensive than paying dividends. Dividends which were the bedrock of funds that used to be for "Widows & Orphans".

> But another factor has been companies' use of their spare cash to buy back their stock. This makes earnings per share rise faster. American firms announced buy-backs worth $671 billion last year, or about 3.9% of GDP, and have made plans for nearly $300 billion this year, according to TrimTabs, a data service. That is more than four times the money placed into equity funds by retail and institutional investors. source: The Economist

general@GordonTLong.com

2-Consumption Reduces Available Savings

What we forget is that consumption directly subtracts from savings. It seems an arcane point today with the word savings having become almost obsolete to most American households. When you have a 70% consumption economy it leaves less and less savings available for Investment.

United States & China
GDP Breakdown 2009

	United States	China
Personal Consumption Expenditure	71%	35%
Gross Fixed Capital Formation	16%	45%
Net Exports	-3%	4%
Government Spending (Now 20-24%)	17%	13%

As governments at all levels become larger they additionally consume savings.

This is occurring because the expansion of credit through Quantitative Easing is replacing savings. As Richard Duncan writes in the New Depression, "Creditism" has now replaced "Capitalism".

3-Bad Money Forces out Good Money via Malinvestment

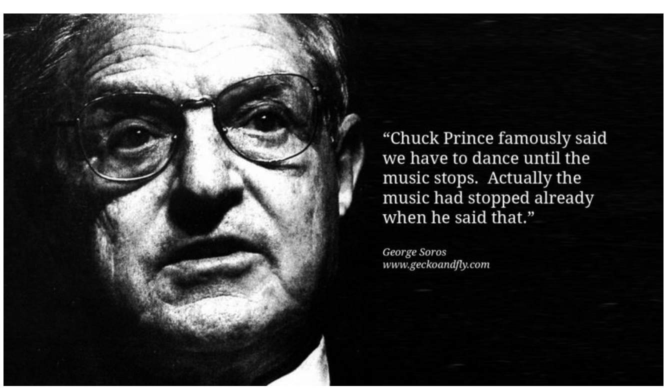
When the Central Banks increase their Balance Sheets by $10 Trillion, this money & credit explodes onto the scene in a manner where half baked ideas, which can only be considered "Malinvestment", often place destabilizing pressures on proven business models.

It is the old adage: *"Bad Money Forces out Good Money".*

The former CEO of Citigroup, prior to the Financial Crisis, is often cited as justifying the excessive risks being taken by his organization (which subsequently needed to be bailed out by the tax payer), as "We have to dance until the music stops". He felt he had no choice.

If Citigroup didn't make bad mortgage loans, someone else would and Citi would lose to competitors, the stock would suffer and management would be summarily replaced.

This is what happens when you have negative real rates for as historically long as QE has dictated.



4-Shrinking Aggregate Demand as Real Disposable Incomes Shrink

As Nobel Economist Milton Friedman so famously stated:

"Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."

Printing money or expanding credit creates inflation.

We have inflation in basic needs like food, education, healthcare etc., contrary to the government's CPI.

But even using their understated numbers we still have negative real disposable income. This is dramatically pressuring aggregate demand.

Top line growth by corporations is flat in nominal terms and falling in real terms. Inflationary pressures without job and wage growth is effectively killing the "golden goose". This is the destruction that sustained QE is causing.

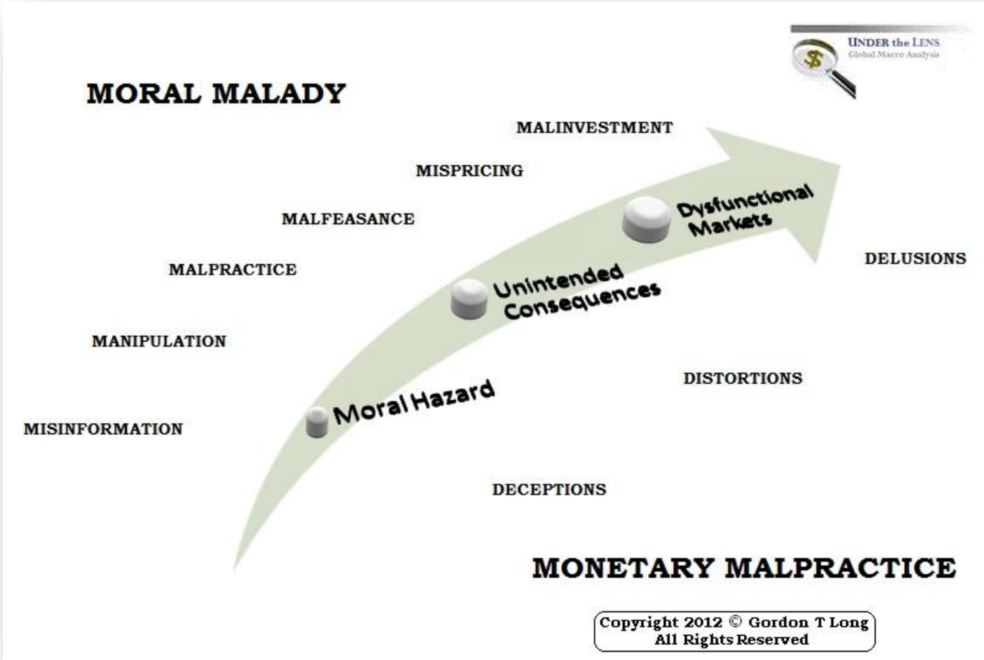
5-Mispricing of Risk & Lack of Price Discovery

For a number of years now we have followed the evolution of the GordonTLong.com graphic (below) and how Monetary Policy via QE 1, 2 & 3 and Operation Twist has fostered a lack of Price Discovery and the Mispricing of Risk.

When the control policies of Financial Repression are employed the elements of Moral Hazard and Unintended Consequences lead to Dysfunctional Markets. Because of misinformation, distortions and deceptions the markets are unable to correctly price risk.

As such they inevitably become dysfunctional in delivering the mechanics and feedback loops required for a capitalist system to function properly.

Distortions & delusions (like the Bernanke Put) remove effective Price Discovery from the capital markets.



6-Capital Destruction via Wasted Malinvestment

There are endless examples of waste and corruption that comes with easy, cheap and excessive credit.

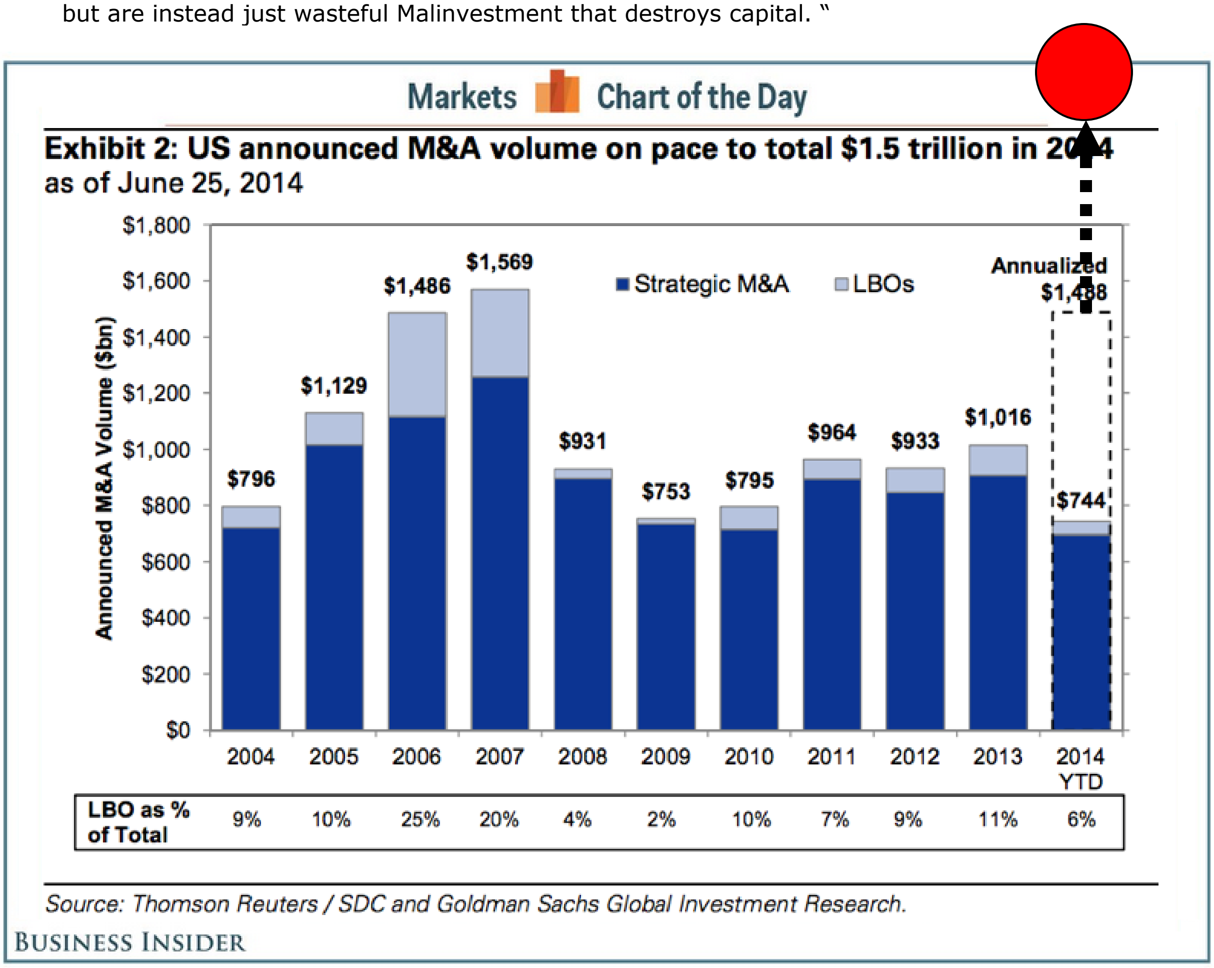
A Bridge to Nowhere!

The one that is on my desk today is articulated quite well by Doug French of the Canadian von Mises organization. I quote:

> "The world's central bankers have given companies the urge to merge. Merger and Acquisition (M&A) activity has **already reached $2.2 trillion** this year according to Thomson Reuters Deals Intelligence, up 70% from this time a year ago.

The deals are big, with eight acquisitions, each over $5 billion, being announced in just a single week in July.

However CEO buying sprees do not create new jobs and new products that make our lives better, but are instead just wasteful Malinvestment that destroys capital. "



7-Reduced Risk Taking via Financial Engineering

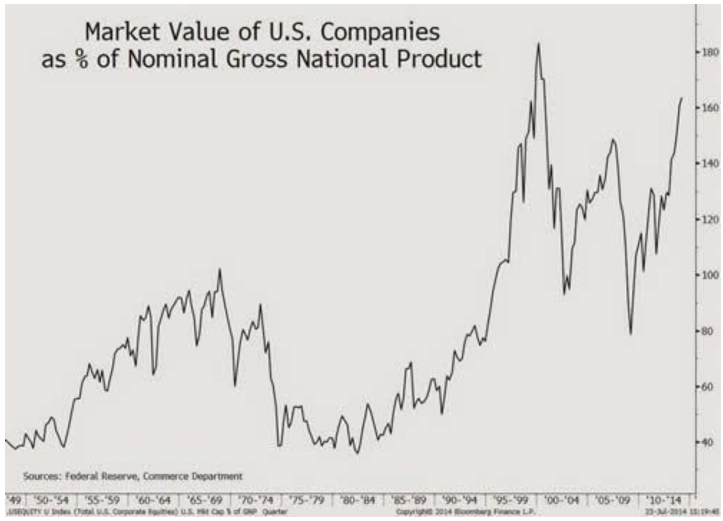
Easy, cheap and excessive credit begets FINANCIAL ENGINEERING which discourages Risk Taking.

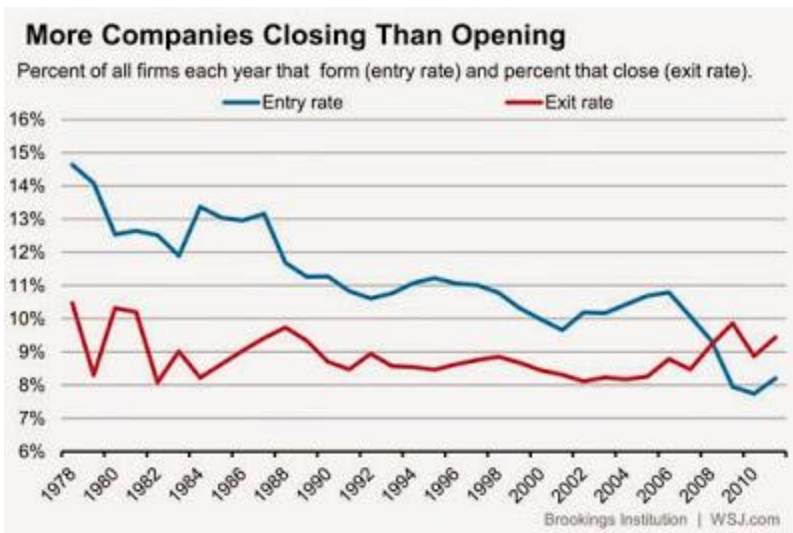
Capitalism is about REWARDING Risk Taking. Today through financial accounting games such as:

- Off balance sheet entities,
- Contingent liability accounting,
- Double Dutch Irish Sandwich tax structures,
- Inversions etc,

…we now avoid risk at all cost for games of 'trickery'.

With manufacturing corporations having product life cycles that are so short that more than 90% of next year's unproven products are still on the design board, risk is larger than ever before. Few want to play the game any longer when accounting and regulatory arbitrage offer less risky and more lucrative returns.



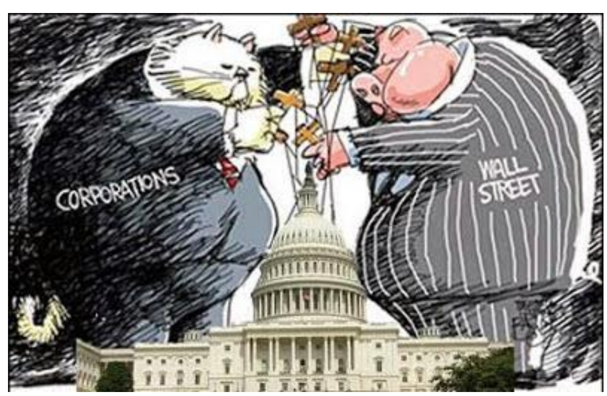


8-Government Dominates Economy & Forces Corporate Re-Focus

Never forget that the Federal Reserve's primary raison d'être is to finance the Government. Easy, cheap and excessive credit is at its core about the size of the government deficits and its inability to pay for its expenditures.

With the advent of fiat currencies and unsound money Governments have increased in size and as a consequence catering to them has increasingly become the focus of companies and innovation. There is tremendous innovation going on in the Security & Surveillance industry. All of this serves the government but it is an unproductive investment of savings from a capitalist perspective.

Governments don't produce wealth. They simply shift it from those that DO to those they CHOOSE.



Quantitative Easing has been allowing this in a massive way.

9-More for Less versus Less for More

When capitalism is working properly and risk taking is rewarded the consumer "gets more for less". They get more value for their hard earned wages and savings.

When it isn't and risk taking and investment are reduced the consumer inevitably "gets less for more".

The squeeze comes on the offering and product. It takes many forms but the most blatant on my desk this morning is the soda industries shift to smaller cans. We are told by spin doctors that this is to help us reduce our calorie intake. How many believe that? Of course you don't because you have become accustomed since Quantitative Easing began that you are getting less and less with every debased dollar you spend.

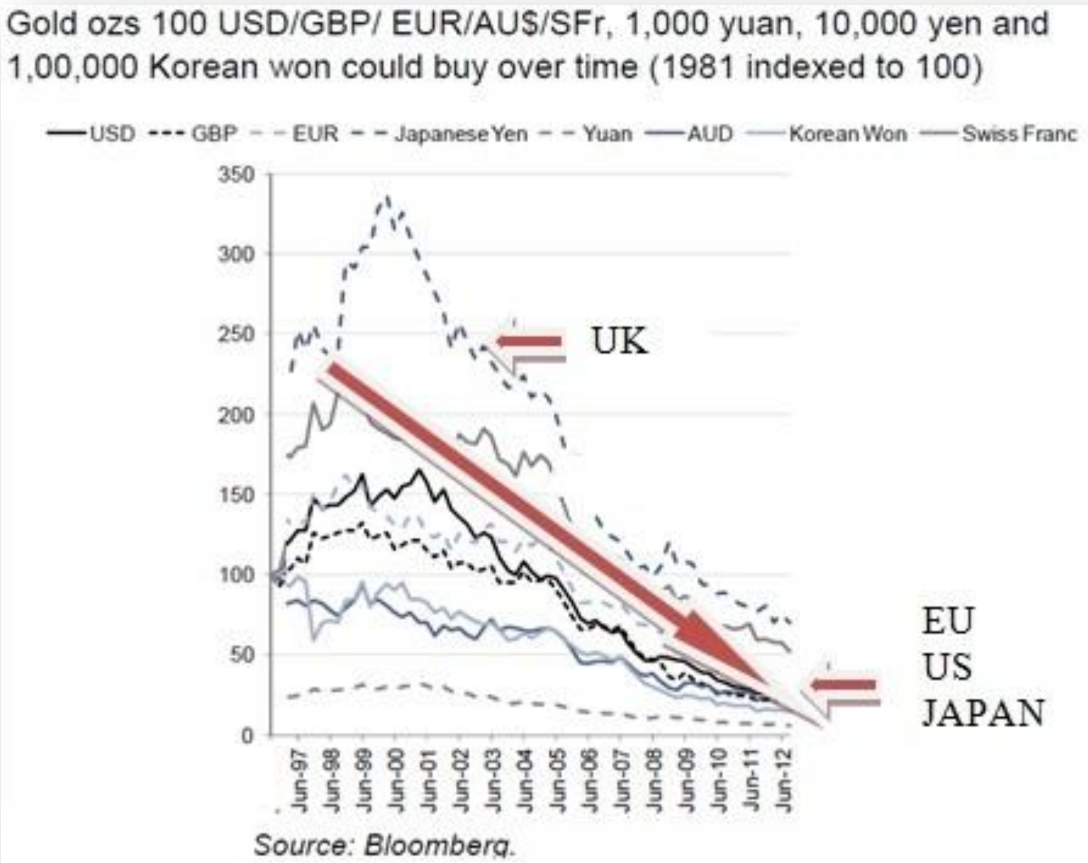
> "... your [Apple's] 7.9-inch tablet has far fewer pixels than the competing 7-inch tablets! You're cramming a worse screen in there, charging more, and accusing others of compromise? Ballsy."
>
> — Gizmodo

10-A Disguised Currency War versus 1920's Style Trade Wars

If you live outside the economies of these developed economies it is very clear to you that Quantitative Easing is nothing more than a debasement strategy similar to the Trade Wars during the last deflationary era of the 1920-30's.

They call it Currency Wars but it is about attempting to debase your currency by printing more of it into circulation. The cheaper your currency the more competitive your export products are.

If you were the strategist in charge of a Currency War strategy, a sustained Quantitative Easing Policy would be exactly what the doctor would order. Thank you Dr. Bernanke and Dr. Yellen.



11-Over-Regulated & Central Control to Administer Means Uncertainty

When faced with increased regulatory interference, firms respond by experimenting, making riskier mergers & acquisitions — and consequently more mistakes according to Peter Klein in his book [The Capitalist and the Entrepreneur](#).

In the book [The Synergy Trap](#), Mark Sirower says valuation models turn on three things:

- free-cash-flow forecasts,
- residual value, and
- a discount rate.

All three are heavily influenced by Fed policy and obviously the low interest rate policies of ZIRP and Quantitative Easing.

The cost of capital is integral to making these assumptions. The lower the assumed interest rate or cost of capital, the higher the price for the acquisition that the models will justify.

Once interest rates go up, these valuation models will be blown to pieces. Regulations go hand in hand with Fed Policy Initiatives such as QE and as a consequence corporate executive behavior shifts in the functioning of capital allocation.

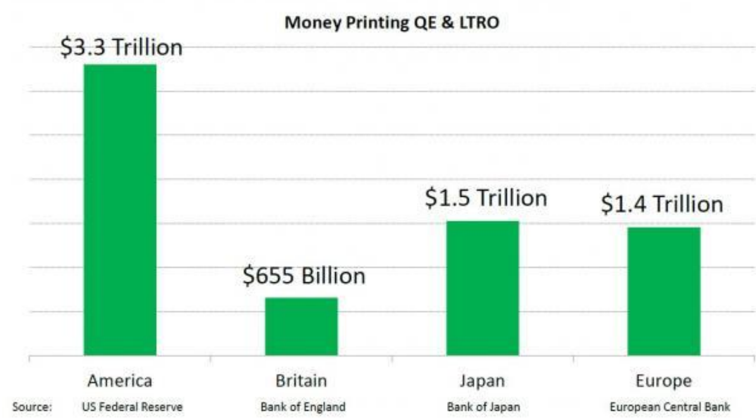
12-Impaired Central Bank Balance Sheet Limits Economic Stability Options

It comes as no surprise that the Balance Sheets of the Central Banks and the Federal Reserve & Japan in particular have become "compromised". [Any buffer required to address a major new crisis shock has already been been spent.]

For a well functioning capitalist system to perform it needs the certainty of government policy, financial stability and the rule of law. Quantitative Easing is bringing all of these more and more into question by the private sector.

Again uncertainty limits investment and that after all is what the capitalist system is about – investment!

Chart 2: Accumulated Money Printing by central banks



How This Will End

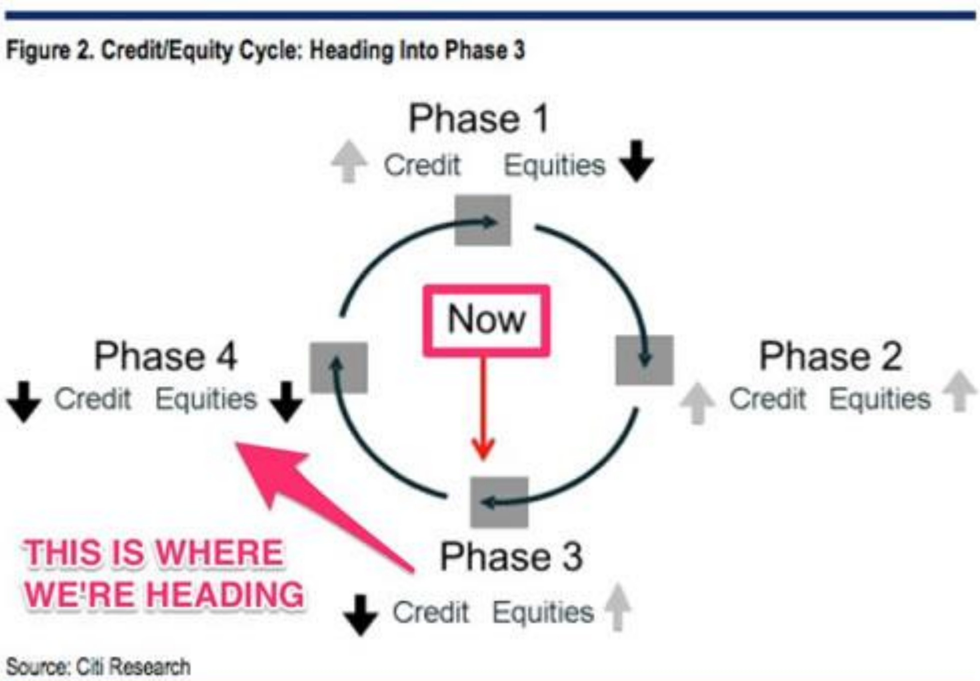
The Exploding Muni, Pension & Entitlements Bombs

We have a ticking time bomb when it comes to Municipal government funding, Pension & Entitlements. We have:

- An Imploding municipal problem (like Detroit, Flint and Puerto Rico and many more to come),
- A $5T underfunded Pension Problem with already low yields,
- An $84T underfunded US Social Security and Medicare entitlement problem.

Debt is going to explode higher and the Federal Reserve will be forced to continue expanding its balance sheet.

This only goes on for so long.



Citi analyst Rob Buckland has published this diagram of where he thinks we are in the economic cycle, and it's slightly terrifying. Basically, we're in "Phase 3" of a four-phase credit/equity cycle.

In Buckland's theory — originally developed by Citi's Matt King— that's the phase in which irrational bubbles form right before everything comes crashing down again. In Buckland's telling, the economy goes through four cycles.

> **Phase 1:** This begins at the end of a recession, when interest rates have fallen, money is cheap, but stocks are still battered.
> **Phase 2:** A bull market sets in during phase 2, when stocks start to rise as easy credit lubricates the economy.

Phase 3: This is the tricky part. Stocks are still flying high, but credits spreads are widening as investors become increasingly unwilling to finance further risk. Corporate CEOs have now experienced a lengthy period of gains and become risk-happy. (And we'd note that central banks are already talking about tightening credit by raising interest rates.) Bubbles can form in Phase 3, Buckland says, as the high-flying stock market ignores the early warning signs of the deteriorating credit market. Hello, tech startup IPOs!
Phase 4: Stocks react to the lack of available credit by collapsing, and we see the kinds of things you get in a recession: "This is the classic bear market, when equity and credit prices fall together. It is usually associated with collapsing profits and worsening balance sheets," Buckland says.

We're in Phase 3 right now, Buckland says, but we may not be ***very far*** into it.

Here's Buckland's checklist of warning signs for Phase 3. Highlighted are some things that should scare you:

Figure 14. Checklist For End Of Phase 3

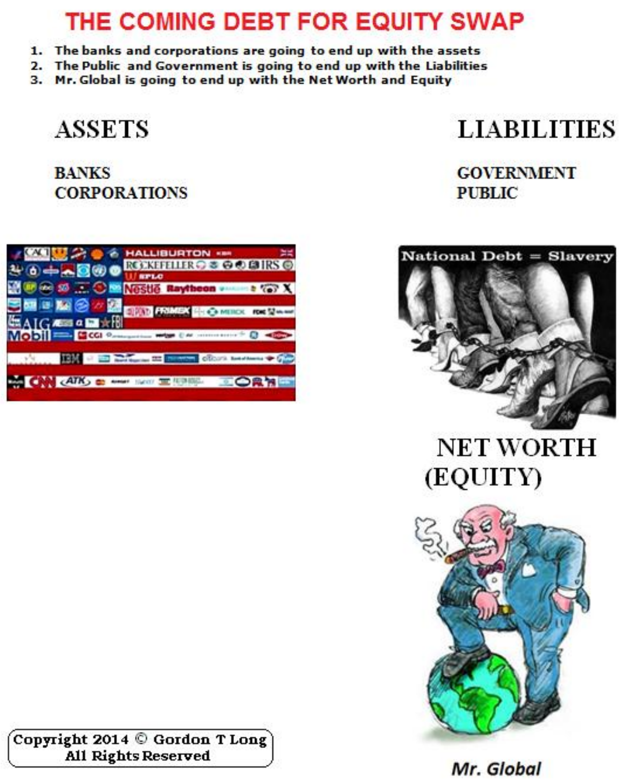
	Previous End Of Phase 3	Now	Should we be worried?
Global Equity Valuations			
CAPE	>29	21	No
PB	>2.6	2.2	No
DY	<2.2	2.5	No
US Yield Curve (10Y minus 2Y)	<0.5	2	No
Global EPS	> 20% fall in next 2 years	We expect 9-10% growth in 2014 and 2015	No
Global Capex	High YoY Capex Growth (>10%)	c3%	No
Global RoE	High (>13%)	12%	No
Net Debt/EBITDA (US ex Fins)	High (> 1.4x)	1.2x (but rising)	Perhaps
M&A	High (>2.5% of Market Cap)	1.5% (but rising)	No
IPOs	High (0.4% of Market Cap)	0.40%	Yes
US HY Spread	600-700 bps	400bps	Not yet

Source: Citi Research

The Massive Debt for Equity Swap

Mr. Global: Assets, Liabilities and Equity

What we eventually will see in my estimation is effectively the biggest debt for Equity Swap in history.



I laid this out in last month's MMC report

Gordon T Long
Publisher & Editor
general@GordonTLong.com