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“Fed UP: Rebels without a clue”

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There is a little rebel in all of us. Whether it is our first sip of beer, taking a drag off a cigarette or breaking curfew, at some point, we all test or experiment with boundaries—physical, social or legal. For better or for worse, this rebellious streak tends to be most pronounced in our teenage years. We are unwilling to listen to logic or wisdom. We pursue the wrong choices even if we know that they are self-destructive. We continue to ignore our better judgment even when the evidence overwhelmingly suggests we are on the wrong course. We are determined to be right even if we are wrong. While age dulls this rebel impulse in many, for some, it takes an accident or crisis to right their paths.

Perhaps the most iconic rebel image is James Dean’s portrayal of the character Jim Stark in the classic 1955 film *Rebel Without a Cause*. Epitomizing the poor choices of youth is the famous scene depicting Jim and his adversary drag racing towards a cliff in a game of “chicken.” The first one to stop would incur the social stigma of being a chicken. As the scene tragically depicts, in high-risk games there often is not time to reverse course to avoid a catastrophe.

Janet Yellen is no teenager, yet, she appears unswerving in pursuing a questionable policy stratagem. The logic, wisdom and evidence of the global financial system are screaming that we are heading for a policy cliff. At this point, there may be no way to avoid another financial disaster. It is not advisable to fool with economic cycles.

By now, many of us are familiar with the concept of business cycles. As a new school year begins, numerous introduction to economics students are learning that unmanaged capitalist systems will naturally experience fluctuations in economic activity and that is a good thing. Expansion phases tend to generate excess demand leading to shortages, inflation and euphoria. Whereas, contractions are characterized by stagnation, abundance and fear. The very nature of accumulation and liquidation is cyclical. While every economic cycle is slightly different and largely unpredictable, there are a number of common factors.

Risk tends to increase as the expansion progresses. Rising prices and confidence are early indicators of excess. Further, rising prices support credit expansion and leverage. The yield curve tends to invert. The inevitable pull back or recession sows the seeds for the next cycle as output drops, bankruptcies occur and unemployment rises. Central bank action is most effective as a counter-cyclical policy. A crisis usually serves as a catalyst for government or central bank intervention. It is a questionable tool to promote prosperity and growth in perpetuity, however.

Economies exhibit a natural counter-cyclicality to them. The boom may feel the best but produces the worst long-term returns for the investor. Asset valuations often become stretched and unjustified leading to investor disappointment. Much to the contrary, the bust, despite its association with despair, offers the greatest potential to reward the patient investor.

Capitalist prosperity, however, was never meant to be linear and forever. It is intended to be cyclical, uneven and fair. For Karl Marx, capitalism's boom and bust cycles "sow the seeds of its own destruction." It can also, if left untethered, stimulate the seeds of its success.

Generally, the overinvestment during the boom cycle survives. The progress of capitalism occurs in steps. Two steps forward and one step back. Losses are as important as gains in that they establish the potential for high returns. It is this potential of high returns which incentivizes capitalists to employ capital. Meanwhile, low returns are generally associated with less opportunity and greater risk.

The opposite of capitalism is centralized planning. Experiments with trying to smooth the economic cycle through fiscal and monetary policies are doomed to fail. Nevertheless, despite history being replete with examples of failed attempts, we continue to try.

Today, the massive scale of global indebtedness has constrained the use of fiscal stimulus. In the United States, political gridlock has made infrastructure spending difficult if not impossible. European governments are constrained by the Maastricht Treaty which attempts to promote sound fiscal policy by member states. Japan has engaged in countless stimulus programs without success because of headwinds from demographic trends. Only China has adopted a freewheeling approach to spending. Yet, debt levels in China are approaching unsustainable levels at a time when growth is moderating. Chinese policy is also becoming dangerously constrained.

So, we have driven this tepid recovery on the back of monetary policy. Unfortunately, monetary policy is far better suited to cure the ills of sick financial systems rather than economic ones. Easy money can promote liquidity but not solvency. It can promote higher stock valuations but not earnings. To the extent that it has encouraged greater debt, it may be a hindrance to growth. Wall Street has benefited at the expense of Main Street. Debtors have been rewarded at the expense of savers. The resulting wealth creation has not trickled down as anticipated. Lower return and higher risk expectations have encouraged greater savings from savers. Japan has experienced similar conditions for over 20 years. Why don't we get it?

Experimentation is a major part of rebellion. Central bankers are totally committed at this point to their policy experimentation. Like Jim Stark speeding towards the precipice, it is far easier to keep moving forward than shift into reverse. Their logic suggests to them that they just have to do more to create inflation. But is inflation a good thing? Their wisdom is that they are on the right course; they just need to stay committed. What evidence supports the case that we are on the correct course? Can encouraging more bad behavior ever lead to good behavior?

At some point, a teenager's parents must face the realization that they are not going to determine the outcome. More rules and logical argument will not sway a rebellious teen. Mom and Dad are left to rationalize and seek comfort in the fact that rebellion is just a phase. Youths soon abandon destructive behaviors, for the most part, as rebellion infrequently wins out over logic and wisdom. Central banks are just beginning to realize their ineffectiveness. Like the parents of the rebellious teen, we are "Fed UP" and hope for the best, believing that this too is just a phase.

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