U.S. Rates Strategy
A Look at 2014 and Beyond

"Capitalism is the worst economic system, except for all the others" - Winston Churchill

A Look at 2014 and Beyond

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A Look at 2014 and Beyond

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Introduction

Modern day capitalism appears to need a different moniker. Today's markets and business activity are distorted by the interference of lawmakers, central banks, and regulators. 'Free markets' are simply less free.

Governments have been assuming greater control in an attempt to end recurring financial crises. Prior to 2008 (and under a Greenspan Fed), finance, in general, was viewed as self-stabilizing. Today, however, it is viewed as self-destructing. Policy makers had always believed that they had the ability to 'clean up' after excesses (i.e., bubbles) unwound[1]. They had become accustomed to 'after-the-fact' crisis management, as opposed to making the politically difficult decisions that could have prevented imbalances or financial crises in the first place. (It was the 2008 crisis that inspired US policy-makers to try to end this pattern by being more proactive.)

Over the past several decades, every time that there was a dip in the business cycle (a decline of economic output), monetary or fiscal stimulus would be initiated in an attempt to halt, reverse, or ameliorate the trend. The intensity and direction of business cycles were, therefore, purposefully influenced by policy. Unfortunately, the chronic desire for growth has depleted policy-makers' monetary as well as fiscal arsenals, leaving the US economy at a critical juncture.

The ability of policy makers to reverse the ebbs in economic activity are now severely limited, while the importance that Fed initiatives succeed has never been more paramount. This is the primary reason that the Fed is being overly-accommodative, even as the recovery heals.

Specifically, years of deficit spending have pushed governments to troublesome levels of indebtedness at the same time that central banks have stair-stepped official interest rates all the way to the 'zero lower bound'. This has forced a reliance on unconventional measures. It is difficult to envision from where the next dose of official stimulus might come.

Recent regulation, such as Dodd-Frank, the Volker Rule and Basel are all attempts at gaining a foothold on systemic risk. Fed policy is trying to keep markets stable as these new rules, which act as economic headwinds, are applied. Turbulence typically arises when old structures are replaced with new ones.

<u>Most new regulatory rules inadvertently decrease market liquidity, the consequences of which will be a main issue for capital markets in 2014</u>. Furthermore, below the surface, financial and social pressures are intensifying into what is likely to become an unsteady and combustible situation elevating market volatilities.

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[1] http://kansascityfed.org/publicat/sympos/2002/pdf/S02Greenspan.pdf

Adding to the pressures, as capitalism has advanced in recent years, it has come under considerable strain. In a capitalist society, there is a constant push for corporations to improve profit margins; this goal is typically accomplished through competitive gains brought on by productivity. However, productivity gains are acting as strong drags on the Fed's dual mandates of full employment and price stability (more on this point later).

Moreover, the use of technology to improve productivity and profit margins demands higher skills from workers, thus eliminating many jobs. Poor demographics in developed-world countries are economic headwinds as well, since fewer workers are supporting more retirees. In turn, fiscal budgets are being negatively impacted.

Eventually, new and adjusting policies, deficits, depleted fiscal budgets, and the elimination of mid-level jobs will mean that many peoples' standard of living will be negatively impacted; this in turn, may progressively lead people to decide that governments are failing them. The social contract already appears to be fraying globally, witnessed by protests, unrest, and mounting support for radical parties.

Subsequent sections will discuss: wealth inequality; social unrest; strains on Capitalism; talking-points from President Obama, The Pope, and Karl Marx; and governmental policy responses and how they have affected investor behavior and market liquidity.

Inequality

The topic of growing wealth and income inequality is a conversation that is advancing in importance and frequency. Advocates of capitalism espouse that free-market systems are vastly superior to any alternatives and cite the fact that hundreds of millions of people have been lifted out of poverty and billions have had their living standards improved. However, critics maintain that capitalistic pursuits of growth and real capital appreciation result in redistribution of income from labor to capital - and from wages to profits - causing ever-growing income and wealth disparities.

This and other such criticisms of capitalism have fashioned a rebirth of the ideas of Karl Marx who detailed the inherent flaws of the capitalist model. Over 140 years ago, he described in great detail how embedded flaws would eventually cause the capitalistic model to implode; it would be brought to collapse either by revolt or a morph into Socialism, or it would give rise to dictators or despotic leaders. His conclusions have been widely criticized; nonetheless, the construct of his arguments were brilliantly assembled. [Note: According to The Guinness Book of World Records, Marx's Communist Manifesto is the second best-selling book of all time (after the Bible); and, sales of Marx's masterpiece Das Kapital have soared since the 2008 crisis].

President Obama and newly elected Mayor DeBlasio of New York City have expressed concern many times over the wealth-divide. Voters have appeared to be energized by the rhetoric: DeBlasio won his election by saying inequality would be his top focus; the President's State of the Union addresses and majority of speeches discuss economic inequality. He even called it "the defining challenge of our time".

In November, in his first Apostolic Exhortation "Evangelii Gaudium"[2], Pope Francis weighed-in on many of the central conversations of our time; including his economic theories and thoughts on inequality and capitalism. It was widely reported when the highly-respected Pope called capitalism "unjust at its root". Capitalism is (arguably) the most successful antipoverty program in history; however until its economic activity and exclusive pursuit of profits adopt broader meaning vis a vis a sense of moral responsibility, it will be difficult for the Pope to defend it. (Because his words are so interesting, a passage of his words can be found in Appenidx I)

The President uses the topic of inequality resourcefully. On the one hand, President Obama denounces the "trickle-down" wealth policies of the Fed; however he favors the rock-bottom interest rates that drive money into equities and allow more affordable funding for government (deficit) spending programs.

Critics argue that the President demonizes the rich, leading to accusations that he is inciting class warfare. They further argue that he "fires-up" the masses by misleadingly and disingenuously blaming the rich and Republicans, rather than blaming Fed policies, globalization, Capitalism itself, or other relevant factors that lead to wealth disparities.

When income gaps are referenced, income is rarely defined. When it is defined, it may only take reportable taxable income into account, when this may not represent the entire story. This definition fails to take into account a highly progressive income tax system, or social security, Medicaid, food stamps and a host of other government programs and subsidies. There is some tipping point when a progressive and heavily subsidized system provides the wrong incentives for everyone. Those paying the most believe that they can use their money more productively than the government. They simply do not trust how the government ultimately chooses to spend its revenue. Nonetheless, the strategy of how, or whether, to address the issue of income inequality is a key factor polarizing Washington's policy makers.

The issue is complicated, but not as black and white as some politicians infer that when the rich benefit, it is at the expense of the poor. Empirical evidence suggests that when the economic pie grows, it grows larger for all[3]. Conversely, there is little argument that when the economy turns down, it is the rich who can weather the storm better; but, again, this does not mean it is the fault of the rich.

The public sector drive for equal opportunity is a worthwhile pursuit, but it does not necessarily mean equal outcomes. It could be argued that out-sized compensation at the top is not a problem as long as it reflects one's contribution to society. In this manner, those who are most entrepreneurial are rewarded accordingly.

Research by the World Bank suggests that for the first time in a few centuries the distribution across global households has become *less* unequal. However, the reduction in inequality is the consequence of fast growth of average incomes in large poor countries like China and India.

[2] http://www.vatican.va/holy_father/francesco/apost_exhortations/documents/papa-francesco_esortazione-ap_20131124_evangelii-gaudium_en.html#I. Some_challenges_of_today's_world

[3] http://www.elsevier.pt/en/revistas/cuadernos-economia-329/artigo/is-economic-growth-sufficient-for-poverty-alleviation-empirical-90153606

The report notes rising inequality within almost all countries[4]. The paper says that lower and middle-income groups of high-income countries did poorly, while the world's richest people did extraordinarily well.

Many books and economic papers have been written trying to explain how technology and offshoring have changed the structure of labor demand. Alan Manning of the London School Economics coined the phrase "job polarization". He offered an explanation and then concluded similarly to the World Bank paper that employment (over the last decade) rose strongly for top income earners, and modestly at the bottom, but middle-skill jobs disappeared.

The unfortunate side of Moore's Law[5] is that the technological gains made in advancing mechanization, robotics, and algorithmic software have led to changes in labor demand where some people – despite being willing and able to work – have no economic value as employees. Adaptation through education and skills re-training is imperative.

It might be fair to say that entrepreneurialism is good, but capitalism is good only up until a certain point. However, replacing a flawed structure with another flawed structure only results in a whole set of different problems.

At a minimum, attention to the topic of inequality has become widespread, partially due to President Obama's frequent discourses on the matter. Regardless of where one stands on the topic, most would agree that perpetually growing inequality is an economic headwind and unsustainable and, therefore, it is a problem for everyone until it is effectively addressed.

Most importantly, however, Marx's endorsement of social revolt, Obama's push for redistribution policies, or *too progressive* an economic system, or an overall drift away from Capitalism into Socialism, are not the answers. The conversation has become such an important and recurring one that it seems sensible to discuss it in greater detail below.

Capitalism and Karl Marx

Capitalism is a social economic system based upon the principle of individual rights, where trade, industry and the means of production are controlled by private owners with the goal of making profits in a market economy[6]. Its characteristics include capital accumulation and wage labor, with parties transacting after agreeing to a price at which assets, goods, or services are exchanged.

In a pure capitalist structure the sole quest is growth to ensure the real appreciation of capital. Therefore, since shareholders want the highest return on their investment, corporate leaders and managers are incentivized to achieve this goal at almost any cost. The best way to achieve this goal is to improve productivity (i.e. increase output per hour worked).

Marx is widely known for his critique of capitalism and for recommending that it be replaced with a communist society. However his critique was in fact actually guarded and two-sided. On

[4] http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-6259
[5] http://www.mooreslaw.org/
[6] http://www.thefreedictionary.com/capitalism

the one hand, it is widely known that he believed the defining features of capitalism were alienation, exploitation, and recurring cyclical depressions that lead to mass unemployment[7].

On the other hand, fewer people are familiar with the fact that Marx said capitalism exhibits "revolutionizing, industrializing and universalizing qualities of development, growth, and progressivity". This basically means capitalism will ignite progress because technological advancement, increased productivity and growth, and scientific revolution are the cornerstone to progress. Marx considered the capitalistic class the more pioneering, due to the constant improvement in the means of production. Capitalism, he noted, can spur considerable growth, because there is incentive to reinvest profits in new technologies and capital equipment.

Marx' major problem with the capitalist system was with its inherently unsolvable contradictions which contained within itself the seeds of its own destruction: weak final demand leads to workers not being hired, and vice versa, in an endless loop which eventually causes capitalism to self-destruct. After all, one person's labor costs are someone else's labor income and consumption[8]. Certainly today's global economy bears some eerily comparable similarities to what Marx predicted.

In 1798 English economist Thomas Malthus developed what is known as the Malthusian Law of Population[9]. The theory states that the population would grow at a geometric rate, while the food supply and the economy would only grow at an arithmetic rate, so general prosperity would be impossible to achieve. The flaw in the theory is the failure to take into account technology, disease, war, natural disasters and the benefits of productivity. As technology is applied more evenly, wage differentials become more pronounced. The theory seems reasonable and it is possible that it might just be taking longer to play out.

With these thoughts in mind, is it possible that capitalism's underlying focus on profits and the necessity for endless purchases of goods and services has a practical limit? The necessity for growth is leading to over-capacity; this in turn is the root cause of deflation, one driver of the Fed's futility. Marx stressed the great increase to human welfare from economic growth under capitalism; however, he argued that the situation becomes less and less beneficial over time. Could this hypothesis explain why this has been the weakest post-recession recovery in history: a recovery that is often referred to as a 'jobless recovery'?

The natural tendencies of capitalist impulses have been launched into hyper-speed due to the convergence of rapid technological advancements, debt expansion, globalization and central bank policies (QE, ZIRP). US Corporate profits have hit record levels recently, while average US incomes have stagnated at levels equivalent to 1970.

The Pope and Karl Marx have outlined negative consequences of the capitalist social structure that have resulted in the budding calls for wealth redistribution and the intensification of social tensions. However, shrinking this divide and easing those tensions, as discussed earlier, are not as straight-forward as they may appear. (Please see Appendix II)

[7] http://qje.oxfordjournals.org/content/95/1/45.abstract
[8] http://www.econ.ucsb.edu/~pjkuhn/Ec250A/Class%20Notes/A_StaticLS.pdf
[9] http://thelawdictionary.org/malthusian-law-of-population/

The Global Economy

Most economists believe that the US economy is gathering momentum. They believe that Europe has bottomed and that commitment to extreme monetary and fiscal policies in Japan is sowing the seeds of a recovery there. While there are pockets of 'green shoots', optimism is being driven as much by hope than fact. The challenges each economy faces are great and beyond the scope of this paper, but it is fair to say that reactive ad hoc crisis management will be in full force.

China could easily fail to achieve even 7% growth, a factor that would contaminate even the rosiest scenarios for the rest of the global economy. Disruptions to China's economic growth will have significant effects on interest rates, commodities (decline on demand-side), equity indices, and currencies around the world. According to a report by China's National Audit Office, local government debt levels, which include debt guarantees and contingent liabilities, have soared to over $3 trillion in the past 3 years.

Since governments are not allowed to tap banks directly, most Chinese debt is parked in SIVs (Special Investment Vehicles). Much of the borrowing is secured by local land values. Local governments have been incentivized to generate high growth rates because they have typically been rewarded by Beijing.

There is plenty of evidence to suggest that China's financial system is already inundated with a significant amount of impaired assets, fragile financial firms, and unpayable loans (and unsettling pollution concerns). Overcapacity is already crimping corporate profits before the costs of credit, electricity, water and other key inputs are set to rise from Beijing's new reform agenda.

In the US, the weak labor recovery has only brought nonfarm payrolls back to where it was in 2006. Today, a good portion of recently created jobs are low-wage and/or part-time. Obamacare has exacerbated this trend, as it incentivizes employers to limit both the number of hours an employee works, and the number of full-time employees in the firm.

Healthcare in the US was in need of a major overhaul, as it is unconscionable for a superpower to tolerate a situation where 50 million citizens lack healthcare coverage. However, despite the good intentions, the structure of Obamacare has deep flaws and it is now conceivable that the incompetence of the rollout risks Obamacare going into a death spiral in 2014. If the huge resources thrown at fixing the problems fails to get more people enrolled, there will be insufficient premiums to allow healthy individuals to adequately subsidize the unhealthy.

The world has been kept on life support mostly by government spending of trillions of dollars and central bank printing of trillions more. Both have boosted asset prices and given the allure of economic progress. Over-zealous regulators, market rule changes, and aggressive policy stimulus have temporarily stabilized markets. Market vigilantes have been hibernating, because unclear investment rules and uncertainties around the ultimate magnitude of stimulus have prevented them from attacking bad policies or distorted asset price valuations.

It is difficult to know the extent that markets and the global economy have benefited from official policy stimulus; however, five years after the crash, economic growth and the labor recovery remain subpar. Strong growth should have been ignited by now.

Most economists still believe in the 'official position' that growth is edging sustainably higher and that interest rates will slowly rise to reflect it. They could be correct, but should it fail to unfold as expected, confidence in the efficacy of official policy will diminish and the social contract will break down further. Since markets require confidence, they will also react accordingly.

Some argue that economic benefits to stimulus have run its course, while the costs from looming unintended consequences have not yet been unleashed. Many believe (and I am one) that the risks and costs of current Fed policy outweigh the benefits.

Experimental Fed Policies

The Fed's asset purchase program (QE) and Zero Interest Rate Policy (ZIRP) are the foremost factors that have widened wealth inequalities. The richest few have benefited the most, simply because the 10% richest Americans own 80% of US stocks. The FOMC believe that its asset-price-inflation-trickle-down-policy leads to spending which ultimately leads to job creation, especially for the poor.

However, several FOMC members themselves have questioned Fed policies, citing that they have not worked as well as had been hoped, and pointing out that aggregate demand has been weak throughout the recovery. To his credit Fed Governor Jeremy Stein broached the subject of unintended consequences of Fed policies when he mentioned in his February paper, "A prolonged period of low interest rates, of the sort we are experiencing today, can create incentives for agents to take on greater duration or credit risk, or to employ additional financial leverage in an effort to 'reach for yield'". [10]

Zero interest rates have incentivized corporations to issue debt (see page 10) in order to capitalize on the historically low interest rates; however, corporations have primarily used the money to pay greater dividends, buyback shares, or modernize plant and equipment.

There is a strong case to be made that holding interest rates at zero for a prolonged period is actually counter-productive to the Fed's efforts to achieve either of its dual mandates. This is because increasing productivity through modernization typically exposes redundancies: it allows firms to lay-off workers, while the improvement in competitiveness allows firms to drop prices.

Furthermore, and as I referenced in my 2013 paper, "Should the marginal propensity to consume of creditors exceed that of debtors, the net effect of redistribution could be to lower household spending rather than raise it. There are some conservative savers who have a predetermined goal in mind for the minimum amount of savings they wish to accumulate over time. Those investors may refuse to move out the risk curve in search of higher yields (likely widening the wealth divide). To them, lower interest rates simply mean a slower rate of accumulation, which likely

[10] http://www.federalreserve.gov/newsevents/speech/stein20130207a.htm

will jeopardize their minimum goal.[11] The only recourse for this investor is to save more, which is the exact opposite intention of the Fed's policy. For example, if interest rates fall from 4% to 3%, an investor would have to increase savings by more than 20% each year to reach the same goal over 30 years."

Another negative result of ZIRP is that banks and other lenders are discouraged from lending due to puny return levels; and, therefore, the Fed's desire to expand lending is compromised. Are lower (or negative) interest rates supposed to increase the incentive to lend money? To assume such is absurd. Although somewhat counter-intuitive, if interest rates rose, then the supply of money willing to be lent would increase due to wider interest margins.

Policies are so unprecedented and unproven that it is possible that the Fed itself has now become a source of financial instability. This could be the case either through the potential fueling of asset bubbles, through its compromised ability to conduct future monetary policy (due to its unwieldy $4 trillion balance sheet), or due to "unknown unknowns"[12].

For example, during the May 'taper-talk', capital began to flow out of emerging markets, placing downward pressure on their respective currencies. This is a major consequence of the downside to the Fed's programs whether the Fed wants to acknowledge it or not.

The Fed has created systemic risk in the world financial system for which it takes little or no responsibility. FOMC members have indicated that what happens outside the US is not their problem. However, in a globalized world economy and as a 'keeper' of the world's reserve currency, the US central bank has an obligation to act responsibly and take those factors into account.

On the other hand, policy makers have a tool through their privileged positions to finance international deficits and budget deficits with their own IOU's (dollars). The US continues to exercise this option to the detriment of the rest of the world.

Investor Behavior

In a low to zero interest rate policy (ZIRP) environment, investors desperately search for yield. This frequently chases investors into assets to which they are ill-suited and to which they will miscalculate liquidity and downside potential. Under ZIRP paradigms, riskier assets become the best-performing. Credit spreads collapse and equities soar.

Massive monetary 'printing' by global central banks has not just emboldened investors, but these actions have collectively changed their behavior and psychology. There is evidence that policies have led to mis-allocation of resources. Investors are emboldened to take what many critics believe is inappropriate or reckless levels of risk. The motto, "Don't fight the Fed" has taken on added meaning. Moral hazard and a deep-seated bullish psychology have become rampant.

Extended Fed promises of lower rates and a continuation of asset purchases even as the economy heals, are conspiring to propel prices ever-upward. Investing today has become mostly about

[11] Walter Bagehot and http://dallasfed.org/assets/documents/institute/wpaper/2012/0126.pdf
[12] http://www.defense.gov/transcripts/transcript.aspx?transcriptid=2636

seeking relative yield, rather than assessing value or determining if the investment's return is sufficient compensation for the risk.

Simply stated, investors and speculators receive ever-lower returns for ever-higher levels of risks. Over time, the ability of an investor to assess an asset's fundamental value becomes ever-increasingly impaired. It should a warning sign to portfolio manager's fiduciary responsibility to maximize return per unit of risk (see market liquidity section).

There have been persistent cycles of asset booms (bubbles) that eventually turned to 'busts'. Very low or negative real rates (seen recently) always create economic distortions and the mispricing of risk, thereby creating asset bubbles. Each 'boom' had some differences, but the common factor has always been easy money which the Fed was too slow to withdraw. Providing liquidity is always easier than taking it away, which is one reason why the Fed has hit the 'zero lower bound' in the first place.

Eventually (un-manipulated) asset prices always return to their fundamental value, which is why bubbles always pop. The FOMC has backed itself into a corner. Current changes in policy are being designed around efforts to manage the unwind process seamlessly. Central bank (and government official's) micro-management appears based on a belief that they can exert an all-encompassing central control over markets and peoples' lives. Those in power have come to believe that policies have a precise effect that can be defined and managed. This is highly unlikely.

In 'normal' times there is a more discernable connection between cause and effect. However, the usual relationships particularly break down during periods of over-indebtedness, unprecedented regulatory changes, and official rates reaching the 'zero lower bound'. Today, the world is far from 'normal'. It is not difficult to imagine the looming fallout from policies that have promoted asset price inflation, and which have materially compromised market liquidity.

In the long run, policies that punish savers at the expense of helping risk-takers and speculators are bad long-run policies for any country. It would be better to transform the country into net savers, rather than to continue to promote policies where growth is reliant on overly-leveraged consumers or speculators, and is micro-managed by attempts of central-control.

Market Liquidity

In 2014, investors have asymmetric risk distributions that are skewed to the downside. Risk-seeking investors are playing a high-stakes 'game of chicken' because the door to exit will be narrow. When risk needs to be pared, market liquidity will be challenging due to fewer market-makers, and potentially fewer new marginal buyers.

The strategy of many investors has been to stay over-weight equities to capitalize on the Fed's overly-accommodative policy; however the intention is for these investors to go the other way when Fed policy is not as 'overly-accommodative'. A small taper does not quite meet that parameter, because the Fed is still providing extraordinary accommodation 'even after the recovery takes hold'. However, there will be a tipping point.

It could be argued that the Fed is only concerned with whether the banking system can withstand financial market fallout. The Fed's emphasis on "vigorously monitoring" markets for 'bubbles' and hints of financial instability, essentially means that it wants to make sure that the banking system can withstand a crisis or steep market sell-off. It is probably correct to assume that the banking system is better prepared. This gives the Fed some comfort, but investors should be worried because the Fed is simply less concerned about anyone else who may have become caught up in the allure of financial speculation or leverage during the half-decade of financial repression.

The details in the next paragraph describe the magnitude of global corporate issuance under a ZIRP regime and an explanation of why market liquidity will be challenging in 2014.

The total outstanding amount of investment grade US corporate bonds (IG) has risen three-fold since 2007, while Primary Dealer inventory has fallen 78% over the same time frame[13]. The outstanding amount of Global Fixed Income securities outstanding has risen even more. Dollar dominated Emerging Market Debt has risen four-fold over this period which poses a whole separate set of problems when the local currency depreciates relative to the dollar. When interest rates begin to rise, many investors who hold this debt will want to hedge or sell their interest rate risk. There simply may not be enough market making outlets to absorb this risk without causing a troublesome overshoot with contagion potential. Unless the economic fundamentals rise to justify equity valuation, then the same logic can be applied to the crowded over-exposures in the equity sector.

Structural Flaws

From the 1950's until his death in 1993, economist Robert Triffin suggested fundamental reforms and improvements that should be made to make the functioning of the international monetary system more stable and less susceptible to rolling crises. He foresaw flaws in a monetary system that is anchored by a paper reserve currency of one country. The term Triffin Dilemma[14] was coined. It described a "doomed" state in which the country supplying the reserve currency had to run an ever-growing deficit to adequately supply the world with its currency (dollars), but a growing deficit would result in ever-declining confidence in that country's currency.

Triffin found it absurd that richer, more-capitalized industrial countries were the main reserve borrowers from the global monetary system. Furthermore, he felt that the US, as the supplier of the world's reserve currency, had enormous inflationary proclivities that would undermine the system. The head of the Chinese central bank, Mr. Zhou, cited Mr. Triffin in a paper calling for a new international reserve currency to replace the dollar. He said, "The desirable goal of reforming the international monetary system is to create an international reserve currency that is disconnected from the individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies".

[13] http://www.treasury.gov/resource-center/data-chart-center/quarterly-refunding/Documents/TBAC%20Discussion%20Charts%20May%202012.pdf (page 4 of Appendix)
[14] http://wps.fep.up.pt/wps/wp469.pdf

Triffin warned that other countries will sooner or later lead the initiative to find an alternative in order to limit their over-dependence on the US. Since US imbalances are growing and the Chinese economy is expected to overtake the US as the world's largest around 2028, this matter is likely to gain momentum. At the moment, there are few, if any, good alternatives, but IMF's Special Drawing Rights (SDRs) are currently the lead candidate.

In the long run, excessive debt levels block the main channels for monetary policy to influence economy activity. High indebtedness requires a minimum degree of economic growth just to ensure debt-servicing is possible. High leverage was a major factor for the severity of the crisis in 2008. The total amount of global fixed income securities outstanding (debt) has now increased three-fold in the past six years to levels not seen since the 1997 Asian crisis. However, there is not the same amount off reckless lending today, as there was prior to the 2008 crisis.

In an unbalanced and highly globalized world reliant of interconnected supply chains, market contagion risks are high. Market contagion can happen quickly and lack of liquidity magnifies the fallout. Remember in 1997, Thailand devalued which was perceived to be a local event. Other devaluations followed in Malaysia, Indonesia and the Philippines. The contagion then spilled into South Korea, Hong Kong and China. The weaker currencies led to a drop in the demand for (more expensive) imported oil from Russia and commodities from Brazil. The drop in demand, ultimately led to the Russian default (oil is responsible for 75% of Russian GDP). Russia and Brazil went into a free fall. Five weeks later Long Term Capital Management was insolvent and world capital markets were on the verge of collapse.

Conclusion

The widening of income and wealth disparities gathers momentum through globalization and Fed policy, and is a natural product of capitalism. Modern global monetary and economic structures are such that imbalances and pressures build perpetually over time. The capitalistic forces that power economic growth have practical limits that will continually be tested socially, environmentally, and technologically.

Adaptation to a modernized world that has pushed productivity into warp-speed must begin with a sense of shared responsibility that leaves no individuals behind. After all, inequality is a constraint on economic growth which ultimately negatively affects everyone. At the international level, macro-prudential policies are necessary to put sovereign nations and capital markets on equal competitive footing, helping to avoid protectionist tendencies. Since these processes improve at a snail's pace, many of the required changes will unfortunately be brought-on by crises.

Several cracks in the foundation of the global monetary system and capitalist model have already manifested themselves from the flaws detailed by Robert Triffin, Pope Francis, Karl Marx, and Alan Manning. The fragility of the system may have been witnessed in May during the first mention of 'taper-talk' when capital quickly began flowing out of certain countries and foreign central banks reacted hastily by hiking interest rates.

Governmental policies are attempting to off-set these fractures and other aggregating imbalances through aggressive regulatory actions and centralized control endeavors. Unfortunately, many policy initiatives attempting to ease the pressures merely redirect them to other focal points.

More so than ever before, political and social (and central bank) factors are having a vast impact on almost every asset class.

One unintended consequence has been the severe damage caused to market liquidity. Investors are currently complacent because the Fed has been providing a market 'put'. Providing the market with easy money has chased investors into the same 'risk-seeking' trades.

Investor behavior is partially being driven by fear of missing the upside: they feel pressure to 'not earn zero', to beat inflation and benchmarks, or to simply outperform their peers. This herd mentality is a powerful, yet dangerous force[15]. It should be a warning of the markets downside potential when markets are confronted with the next "risk-off" catalyst.

Regulations and uncertain rules of trading have thoroughly compromised market liquidity. It is the 'Greater Fool Theory' for investors believe they will be able to monetize profits in aggregate. History shows that periods when central banks pivot from low-rate policy to 'normal' rates has been accompanied by significant market volatility and a tendency for markets to over-predict the markets direction.

The FOMC wants markets to believe that they can navigate a soft landing through micro-managing the unwind process. However, investors and traders care more about the "final destination than the journey", to quote from Mohamed El-Erian, so there will become a time when the Fed tips investors from yield-seeking toward getting 'ahead of the curve'. This point will occur during the process of the Fed lowering the accommodation needle. It will flood markets with sellers who will be hard-pressed to find an economic bid from dealers or market-makers.

The apt analogy is a playground see-saw where investors (and Fed) have a seat firmly on the ground and risk assets dangling in the air. The Fed has started the process of tossing 10 pounds (billions of Treasuries) onto the seat in the air. Every six weeks after each meeting, another 10 pounds will be tossed on the 'high-side'. At some point, a few *heavy* investors will decide to jump-off the seat that they have been sharing with the Fed, causing the high-seat (risk assets) to come crashing down from its high perch. The Fed would like to balance the see-saw, but history suggests the chances are infinitesimal.

The financial crisis that is likely to unfold in 2014 will likely look quite different than the one in 1997 or 2008. The 2014 crisis will likely not cause bank runs or complete dysfunction in the marketplace like it did in 2008. Today, capital can flow much more easily and quickly in a modern world, due to technology and greater investible products, so what may be bad for one country's financial assets may be good for another's.

A 2014 crisis would more likely be one characterized by too many sellers and too few market makers (i.e. lack of market liquidity). As the Fed continues its reduction of asset purchases, more investors will choose to get out of risk assets, causing lower financial asset prices. The lower prices will cause other investors to pare risk and so on. There will be times when lower prices quickly beget even lower prices.

[15] http://www.ijj100.com/uploadFile/affix/0c813c8c787d4963a69710a530a26c9e.pdf

A liquidity-premium will be placed on liquid securities. The process – from the unwinding of five years of QE and ZIRP and so many investors going the same way- will be why the Fed is likely to lose control of the process.

The bottom line is that 2014 will be characterized by intermittent collapses in market liquidity, increases in market volatility, and bouts of market instability.

Happy 2014 and Beyond

-Guy

Appendix I

The Pope specifically said in his first Apostolic Exhortation in November:

> "Today everything comes under the laws of competition and the survival of the fittest, where the powerful feed upon the powerless. As a consequence, masses of people find themselves excluded and marginalized: without work, without possibilities, without any means of escape.
>
> Human beings are themselves considered consumer goods to be used and then discarded. We have created a "throw away" culture which is now spreading. It is no longer simply about exploitation and oppression, but something new. Exclusion ultimately has to do with what it means to be a part of the society in which we live; those excluded are no longer society's underside or its fringes or its disenfranchised – they are no longer even a part of it. The excluded are not the 'exploited' but the outcast, the 'leftovers'.
>
> In this context, some people continue to defend trickle-down theories which assume that economic growth, encouraged by a free market, will inevitably succeed in bringing about greater justice and inclusiveness in the world. This opinion, which has never been confirmed by the facts, expresses a crude and naïve trust in the goodness of those wielding economic power and in the sacralized workings of the prevailing economic system. Meanwhile, the excluded are still waiting. To sustain a lifestyle which excludes others, or to sustain enthusiasm for that selfish ideal, a globalization of indifference has developed. Almost without being aware of it, we end up being incapable of feeling compassion at the outcry of the poor, weeping for other people's pain, and feeling a need to help them, as though all this were someone else's responsibility and not our own. The culture of prosperity deadens us; we are thrilled if the market offers us something new to purchase. In the meantime all those lives stunted for lack of opportunity seem a mere spectacle; they fail to move us.
>
> This imbalance is the result of ideologies which defend the absolute autonomy of the marketplace and financial speculation. Consequently, they reject the right of states, charged with vigilance for the common good, to exercise any form of control. A new tyranny is thus born, invisible and often virtual, which unilaterally and relentlessly imposes its own laws and rules. Debt and the accumulation of interest also make it difficult for countries to realize the potential of their own economies and keep citizens from enjoying their real purchasing power. To all this we can add widespread corruption and self-serving tax evasion, which have taken on worldwide dimensions."[16]

[16] http://www.vatican.va/holy_father/francesco/apost_exhortations/documents/papa-francesco_esortazione-ap_20131124_evangelii-gaudium_en.html (sections 52-56)

Appendix II

The Giving Pledge

One wonderful idea that could delay the Marx-style inevitable-implosion of capitalism is The Giving Pledge[17], founded by Warren Buffett and Bill Gate. It should be a required case study in business schools. The 'Pledge' is a campaign that encourages the wealthiest people in the world to make a commitment to give most of their wealth to philanthropic causes.

It likely came about in a simple way. Once upon a time, Warren and Bill were playing a game of Monopoly and they each got to the point when Warren had vastly more money than the bank, so Bill suggested that he give half of it back to the bank, so they could keep having fun while consuming McDonald Cheeseburgers and Diet Cokes. Thus, a plan was born out of kindness, but could serve a greater purpose of saving contemporary capitalism from its inherent flaws. The plan also falls within the realm of the Pope's plea for more humanity in economic pursuits.

Capitalism is like a game anyway, so once you get to that 'billionaire' status, you have already won. It makes sense to then recycle wealth back into the game similar to the way corporations pump money back into business investment or research and development. Pushing back against Capitalism's natural successes and entrepreneurial spirit in any other way (e.g. taxes, wealth redistribution, penalties, confiscation, anarchy, etc) could have terrible consequences for everyone.

Our schools and universities must adapt to the changing state of labor demand outlined by Alan Manning. A sustainable capitalist system requires it. Technological advancement and the use of robotics have resulted in too many middle-income workers having no economic value as employees.

The new curriculum should include real life examples of the significant changes that resulted from voluntary commitments under The Giving Pledge. The world's better-off should continue to help the poorer to prosper, so educational encouragement can be motivational.

The pursuit of winning - the capitalist game - has to find ways to live compatibly and morally in the confines of the arena, or the game becomes like Pope Francis described:

> "The worship of the ancient golden calf has returned in a new and ruthless guise in the idolatry of money and the dictatorship of an impersonal economy lacking a truly human purpose. The worldwide crisis affecting finance and the economy lays bare their imbalances, and above all, their lack of real concern for human beings."

[17] http://givingpledge.org/

Appendix III

The Times They Are A-Changin'

"Come gather 'round people
Wherever you roam
And admit that the waters
Around you have grown
And accept it that soon
You'll be drenched to the bone
If your time to you
Is worth savin'
Then you better start swimmin'
Or you'll sink like a stone
For the times they are a-changin'.

Come writers and critics
Who prophesize with your pen
And keep your eyes wide
The chance won't come again
And don't speak too soon
For the wheel's still in spin
And there's no tellin' who
That it's namin'
For the loser now
Will be later to win
For the times they are a-changin'.

Come senators, congressmen
Please heed the call
Don't stand in the doorway
Don't block up the hall
For he that gets hurt
Will be he who has stalled
There's a battle outside
And it is ragin'
It'll soon shake your windows
And rattle your walls
For the times they are a-changin'.

Come mothers and fathers
Throughout the land
And don't criticize
What you can't understand
Your sons and your daughters
Are beyond your command
Your old road is
Rapidly agin'
Please get out of the new one
If you can't lend your hand
For the times they are a-changin'.

The line it is drawn
The curse it is cast
The slow one now
Will later be fast
As the present now
Will later be past
The order is
Rapidly fadin'
And the first one now
Will later be last
For the times they are a-changin'." **– Bob Dylan**