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STRATEGIC ECONOMIC DECISIONS

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CLIENT MEMO

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OH MY GOD! IT HAPPENED HERE IN THE ANTIPODE OF GLOUCESTER

– H. Woody Brock in Denmark, Australia –



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OH MY GOD! IT HAPPENED HERE IN THE ANTIPODE OF GLOUCESTER

– H. Woody Brock in Denmark, Australia –

Topic 1: The G-20 Sydney Summit:

Did I truly have to voyage quite literally to the other end of the earth to read in the *Weekend Australian* about a politician prescribing to the entire G-20 summit in Sydney what proper macroeconomics is all about, and what it prescribes for reigniting growth in the world's economies? Apparently I did. The new Australian Treasurer Joe Hockey stated bluntly and correctly what we have been arguing in these pages for four years:

1. 5% G-20 growth is needed if we are to bring down unemployment — especially among the young. The 3% growth we are “accepting” will fail to do so.
2. The most important policy tool needed is strong deregulation of world labor and product markets, whose restrictions and constipation have pushed down growth and raised unemployment for decades. To wit: “Only substantial domestic reform — delivering freedom in the marketplace, delivering less legislation, less tax, more transparent markets, greater competition — only those policies will be the drivers of growth... The only way we can create jobs, the only way we can have fiscal repair, the only way we are going to deliver prosperity is to improve growth everywhere There is a very clear message here: the more regulated the labour market, the higher the unemployment ends up being. And it costs people their jobs and it means that young people in particular lose the opportunity of any job at all.” Slam Dunk!
3. Massive private-public infrastructure investment is long overdue, with concerns about deficits modified by understanding the constructive role of *productive* investment.
4. Monetary policy on its own will not and cannot achieve these long-overdue goals. REPEAT: FED WATCHERS GO JUMP IN THE LAKE.

We have stressed all these points for years, and in so doing far transcended Hockey's common sense level of analysis by drawing upon the “macro-controllability” theorems of Tinbergen and of Arrow-Kurz. These bedrocks of macroeconomic theory demonstrate that Hockey's view is not just another opinion, but is a logical truth derived from first principles.

His views have been supported by many of the politicians meeting in Sydney as well as by corporate luminaries such as UBS Axel Weber, a former President of the German Bundesbank.

The Embarrassing Analyses of Leading US Economic Commentators

In the States, and in most of Europe, pundits during these last five years have not made these points, and instead have focused far too much on monetary policy. The fact that by far the ultra-easiest monetary policy in history failed to bring about satisfactory economic recoveries anywhere is little discussed — even though the reasons why this was true should have been obvious from the start, and should have occasioned a radical change in policy.

Consider Lawrence Summers' widely analyzed comments a few months ago on a forthcoming decade of “secular stagnation.” He largely assumed (rather than derived) his scenario of slow growth. Worse, he failed to point out how policies of the kind Hockey has proposed could generate decent growth as opposed to “stagnation.” That is, if there will be stagnation, it will be because we *choose* it.

Paul Krugman at Princeton endlessly proposes greater fiscal stimulus, but fails to stress the need to placate the bond markets by only borrowing funds that are spent *productively* in accord with the Arrow-Kurz analysis of “optimal fiscal policy.” Of course, productive investment might be good for business (“the rich”) so perhaps Krugman cannot quite bring himself to endorse growth given his tiresome crusade against the rich.

As for Wall Street commentators, all emphasis has been on the Fed and the financial markets, with no writer we know of evincing any understanding of proper macroeconomics at all. These days, when we read about “the economy” in the morning papers, it turns out we are reading about “the markets” as opposed to Main Street. The cart is now before the horse. The analyses are as worthless as they are invalid.

The economics discipline should hang its head in shame. If its analyses have been one-sided and biased towards monetary nonsense, its failure to propose — much less demand — strong

growth policies is reprehensible. Main Street is what matters. “Markets” are epiphenomenal to Main Street at best, and should largely be ignored by policy makers. It is time for the horse to be placed before the cart. It is time to replace concerns about market reactions to “tapering” with concern about 40% unemployment among the young in many nations. Yes, the profession is a mess. Dominated by moral pygmies and mental midgets, to cite Bertrand Russell's celebrated phrase.

Topic 2: A Complete Resolution of the Efficient Market Paradox

The 2013 Nobel Memorial Prize in Economics was a first. Two scholars (Robert Shiller and Eugene Fama) received the prize for utilizing empirical data to arrive at two theories in complete opposition to one another. This has never happened. Is Truth a two-faced Janus? Is there not a paradox lurking here? Indeed there is.

You will receive next week a 25 page **PROFILE** proposing a complete resolution of the paradox of market efficient/inefficiency. This is one of the most serious essays of my career. By introducing a host of new definitions of terms like “irrationality” and “mistakes,” we ascend to a higher level of generality and demonstrate three results. *First*, we show the precise conditions under which Fama's claims (that markets are efficient and that they cannot be out-performed) are true. *Second*, we show the exact conditions under which Shiller's claims (that markets are inefficient and exhibit excess volatility) are true. *Third*, we demonstrate that the fundamental assumption of Behavioral Finance is wrong, namely the assumption that the source of “excess volatility” and “mispricing” in markets is irrationality. It turns out that 95% of total market volatility can be explained by a stochastic general equilibrium model with no assumption of irrationality at all.

Any reader who thinks this issue is merely “academic” is wrong. For while the Fama-Shiller debate is indeed of academic importance, **THE ISSUES INVOLVED HAVE CONSTITUTED THE GREAT DIVIDE IN REAL-WORLD INVESTMENT STRATEGY FOR FIVE DECADES.** To wit, should an investor invest passively, or actively? Nothing less is at stake.

I hope you will find this labor of love on my part one of the most interesting essays you have ever read in finance.

H. Woody Brock
Denmark, Australia
— Where the Indian and Antarctic Oceans join