A call for honest fools

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With public anger at the finance industry growing by the day, "banker greed" and the "bonus culture" are widely blamed for all that is wrong in today's world. From public sector cuts to the neglect of manufacturing to widening disparity between haves and have-nots, disillusionment with the banking industry remains a common and constant theme. The financial problems of today are indeed complex, yet such anger is directed entirely at symptoms rather than underlying causes. A sound analysis of the integrity of any construction must surely begin with that construct's foundations, and the foundations of our capital markets are our central banks. This paper questions the knowledge base upon which central banks act to effectively manipulate capital markets in the name of the common good. It argues that faulty reasoning and presumed knowledge lie at the very core of our capital markets behaviour, and therefore at the very core of today's crises.

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It seems counterintuitive, but "trying harder" doesn't always work. A famous experiment asked groups of people for and against capital punishment to evaluate two separate studies, one for capital punishment and the other against. The group in favour of capital punishment found the study in favour to be more valid, while the group against capital punishment found the study against to be more valid, and that after reading each report, each group's prior beliefs were strengthened as was their hostility to the other. What I found especially fascinating was that when the study was rerun only this time the experimenters explicitly told the subjects to be "strictly unbiased in their judgement" (i.e. "try harder") the effect was to make the polarisation even more pronounced!

It is this aspect to those studies I want to think about here, the incorrect application of faulty models. In essence, that is all that study was really about. Subjects applied a faulty model - a mental algorithm saying "accept only supporting evidence" - which resulted in a biased assessment of the evidence. "Trying harder" did not work because the problem was the faulty model, not the lack of effort and applying that faulty model with more determination just caused an even bigger error. Psychologists have a name for this. They call it the "lost pilot effect" after the lost pilot trying to reassure his passengers by saying, "I have no idea where we're going, but we are making good time!"

Flawed thinking got us into this mess, but rather than changing that flawed thinking, our policy makers are applying it with even more rigour. We have more debt for insolvent borrowers, more financial engineering, more complicated banking regulations, more blaming speculators for everything, more monetary experimentation by central banks. Our policy makers have absolutely no idea what they're doing, but they're giving it a go!

The latest from the Fed provides a wonderful example. Undeterred by the latest calamitous failure of Consumer Price Index (CPI) targeting regimes (a brief history of which will be presented below) it has announced an explicit 2% inflation target. But why? Would an explicit target have made any difference to the last crisis? Will it prevent the next one? And where did this 2% come from? We don't know, but we suspect that past uninformed capital market tinkering has failed to control the uncontrollable, and we are pretty sure these ones will too.

... past uninformed capital market tinkering has failed to control the uncontrollable

In fact, if such tinkering has in the past been the primary cause of crises, then why won't this latest attempt - the 2% inflation target - be the cause of the next one? There are certainly precedents. Targeting stable "prices" isn't a new idea. The first experiment was actually conducted in the US in the 1920s, and apparently it was successful. Indeed, so stable were consumer prices then that the authorities assumed there was no inflationary threat. Moreover, so enamoured were they with this brilliant new idea that stable consumer prices were both a necessary and sufficient condition for economic stability, that the NY Fed adopted it as a policy objective. On January 11th 1925, then-Governor Benjamin Strong wrote to a friend:

"That it was my belief, and I thought it was shared by all others in the Federal Reserve System, that our whole policy in the future, as in the past, would be directed towards the stability of prices so far as it was possible for us to influence prices."

During the 1927 Stabilization hearings before the Committee on Banking and Currency regarding a Bill to amend the Federal Reserve Act to provide for the "stabilization of the price level for commodities in general", the governor was asked if the Fed could stabilize prices more than it had done in the past. Strong replied:

"I personally think that the administration of the Federal Reserve System since the reaction of 1921 has been just as nearly directed as reasonable human wisdom could direct it toward that very object"

Like a driver focused on the speedometer rather than the speed, oblivious to the risk that the speedometer might be faulty, they kept their foot on the gas until they crashed. So focused were they on the stability of the CPI (first chart below), and so confident and convinced that it was the be all and end all of inflation, they completely missed what was happening in the credit markets (second chart below).

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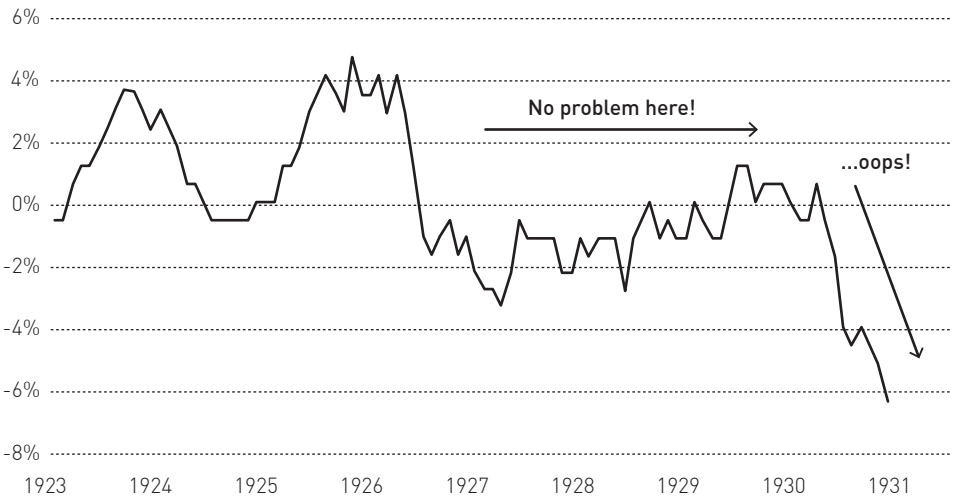
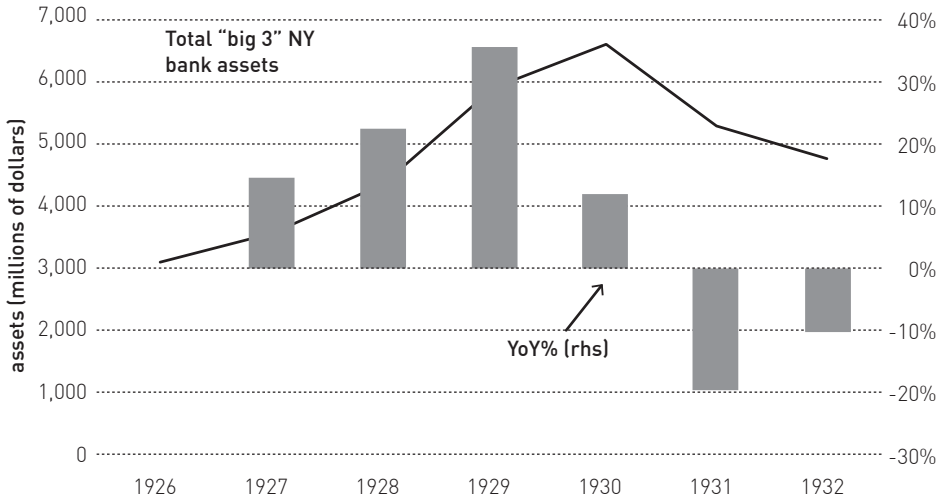
US CPI YoY% in the 1920s



Source: Bloomberg

The warning the Fed weren't watching

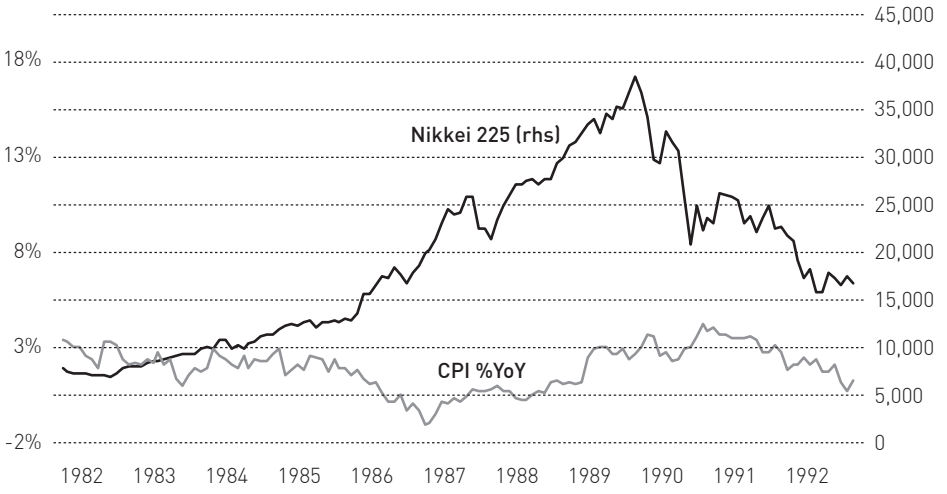


Source: Rötheli (2009)

We know that episode did not end too well. Yet to this day, on the long list of explanations for what put the "Great" into the 1930s Great Depression, the prior credit bubble, which was allowed to develop and was possibly even caused by the monetary authorities' undue attention to an arbitrary variable (consumer prices) and the false sense of security the stability of that variable created, is barely a footnote. Amid the mountains of literature on the "lessons learned from the 1930s" there does not seem to be much on the danger posed to an economy for allowing a committee of economists to tamper with the natural functioning of the market for capital by letting them decide what interest rates should be.

Certainly, the Japanese didn't learn from this past mistake. Allowing themselves the false reassurance there was no inflation problem because there was no CPI inflation in the late 1980s, bank credit was allowed to boom. The consequent inflation of real estate and equity prices was interpreted instead as something miraculous (chart below).

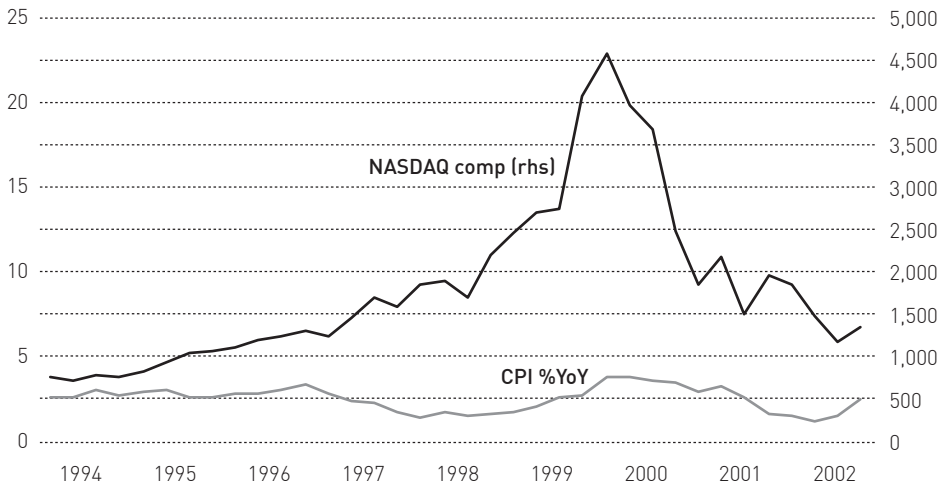
Japan made the same mistake



Source: Bloomberg

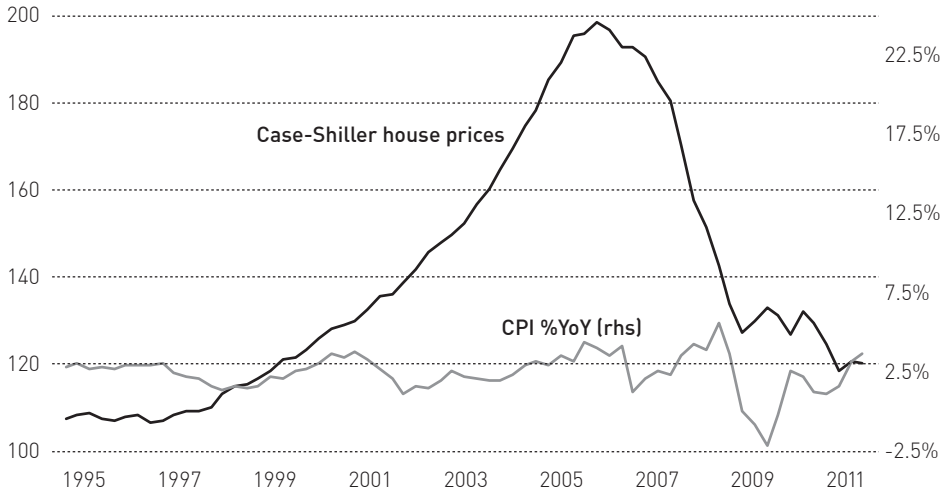
More recently we have experienced the same thing with the tech bubble of the late 1990s and the real estate bubble, which we are still recovering from (see charts below). On each occasion, the monetary authorities were blinded to the runaway inflation in the markets for equities (first chart below) and real estate (second chart below) by stable CPI inflation.

I see no inflation …



Source: Bloomberg

I *still* see no inflation!



Source: Bloomberg, Robert Shiller

Inflation targeting, it seems, has a history of fostering asset bubbles because the notion that a stable CPI equates to a robust economy contains numerous false premises.

The first fallacy is that inflation is measurable. Einstein once had the words "not everything which can be measured counts, and not everything which counts can be measured" on the desk in his office at Princeton. While the world might be simpler if it wasn't so, I believe "inflation" happens to be one of the things which counts but can't be measured. The fact is that once money is created you don't know where it ends up. Maybe it will end up in the consumer goods market, maybe it won't. Or maybe it will be multiplied via the financial

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system into new credit which will inflate asset prices instead. Even then, we don't know which assets.

However, suppose we did know where money would end up, how would you weight them together into one index? Should stock prices be included in the CPI? If so, what should the weight be? And if you're going to add stocks, why not add corporate bonds too? And what should their weight be? And if you're going to add bonds, why not add house prices? Etc. etc. Isn't it obvious that the rich concept of "inflation" is unobservable? So who said that proxying it with a narrow sub-category - consumer prices - was a good idea?

The second erroneous belief is that consumer prices themselves should be as "stable" as possible. But is that correct? Isn't the natural tendency of our species to do more with less, to lower the cost of a given good or service, to "increase productivity"? In other words, isn't "deflation" a part of the human condition? Jeff Bezos, the CEO of Amazon, famously said there were two types of company in the world, those that work to charge more and those that like to charge less. His company, he said, would belong to the second group.

Shouldn't someone warn him of this folly in the pursuit of deflation? Of the untold havoc he's set to unleash by trying to undercut Apple's iPad? And how about those guys at Walmart? Surely they deserve a stern ticking-off, oblivious, it seems, to the downright irresponsibility of their "Everyday Low Prices" strategy? Maybe all the clever economists and Ivy League Nobel Prize winners should make going to Arkansas to explain to the Waltons that they're playing with fire a matter of urgency?

Or maybe the clever economists aren't so clever. Maybe they have it all wrong. Maybe deflation is most painful when there is an excess of debt, and so maybe they shouldn't be encouraging excessive debt accumulation - and the financial excesses and imbalances we today see are associated with it - in the first place, by distorting the interest rate market in the pursuit of aims they don't fully understand the consequences of.

This brings us to a third false premise, that there is some "optimal" rate of consumer price inflation. Judging by the targets of most central banks which have them, that rate is around 2%. But why is it 2%? Why not 3%, or 4%, or 6.78384%? What's so magical about 2%? Where did that number come from?

But why is it 2%? Why not 3%, or 4%, or 6.78384%? What's so magical about 2%? Where did that number come from?

One of my favourite people of the 20th century is Richard Feynman, the Nobel Prize winning physicist who, among other things, pioneered the study of quantum electrodynamics. In a fantastic documentary about him for BBC's Horizon show called "The Pleasure of Finding Things Out", he said something I found moving and profound. He was talking about the "experts" he saw on TV and how, although he didn't have any expertise in the area they claimed to have expertise in, he felt quite sure that they didn't know what they were talking about. He said this:

"There are myths and pseudo science all over the place. I might be quite wrong, maybe they do know all this ... but I don't think I'm wrong, you see I have the advantage of having found out how difficult it is to really know something. How careful you have to be about checking the experiments, how easy it is to make mistakes and fool yourself. I know what it means to know something. And therefore, I see how they get their information and I can't believe that they know it. They haven't done the work necessary, they haven't done the checks necessary, they haven't taken the care necessary. I have a great suspicion that they don't know and that they're intimidating people."

So if I apply Feynman's test and ask myself how hard most economists worked for their knowledge, I can't help thinking they have not worked hard for it at all. I don't think they have worked hard to know what inflation is, or whether it can or should be targeted. I think they have just assumed it, and anyone can do that. As Feynman warned, they've fallen into

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the trap of fooling themselves. They have assumed that inflation can be proxied by the CPI because it is easier to do that, they have assumed that 2% is somehow the right rate for it, and they have assumed they're capable of setting interest rates at the "appropriate" level.

But what if those assumptions are wrong? What if, for example, the "natural" rate of consumer price inflation was 0% and so by trying to keep it at the unnaturally high rate of 2% they've had to artificially goose up the rest of the economy by setting interest rates at an inappropriately low level? And what if, like force-feeding steroids to a horse because you assume it should be running faster, in doing so you kill it, distorting the credit system so grotesquely as to crash the rest of the economy?

They have assumed that wouldn't be a problem, and they assumed that if there was one they would be able to fix it (Ben Bernanke supposedly promised Milton Friedman that there would never be another great depression because the "lessons" had been learned from the 1930s). However, assuming you know how the animal behaves is not the correct way to go about attaining knowledge about how the animal actually behaves. By not attaining the knowledge about how the animal behaves, the animal keeps mauling them.

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Nevertheless, they keep doing it. Now a 2% CPI inflation target is going to make all the difference, and I find it a very strange thing. I just do not understand why they're so sure they know all this stuff despite all the evidence to the contrary. I feel like R.P. McMurphy in One Flew Over the Cuckoo's Nest: "That's right Mr. Martini, there is an Easter Bunny."

The foundational premises on which our capital markets are regulated are demonstrably false. The premise that central banks can manage the economy efficiently by distorting markets on the basis of forecast behaviour has been proven incorrect (price setting has a track record of failure, as does precise forecasting – the official euphemism for 'impossible' appears to be 'difficult'). Is the economy even something which needs to be 'managed'? We are dealing with a complex system. Complex systems self-organise. Why does the bank need to have a target for anything? Why does it have to exist? These are questions that need to be asked.

When power has been given to people who don't seem to know what they don't know, unintended consequences are the rule, not the exception.

Mr. Feynman said something else which I like. He said:

"Ordinary fools are all right; you can talk to them, and try to help them out. But pompous fools - guys who are fools and are covering it all over and impressing people as to how wonderful they are with all this hocus pocus - that I cannot stand! An ordinary fool isn't a faker; an honest fool is all right. But a dishonest fool is terrible!"

I think he's right. A dishonest fool is terrible. Why do we let them run the credit system?

The 300 Club

The 300 Club is a group of leading investment professionals from across the globe who have joined together to respond to an urgent need to raise uncomfortable and fundamental questions about the very foundations of the investment industry and investing. The mission of the 300 Club is to raise awareness about the potential impact of current market thinking and behaviours, and to call for immediate action.

Current economic and investment trends will change the investing landscape over the next two decades and we are at a crisis point which presents huge risks to investors, according to the 300 Club. Moreover, the 300 Club believes that current financial and investment theory and practice run the risk of failing investors at their time of greatest need.

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