



BLIND FAITH

By Steven Romick

October 31, 2012

Blind faith has gotten us into trouble repeatedly throughout history. Just consider the rogue's gallery of false idols, dictators, and charlatans we have followed, hoping for something different, something better. That misplaced conviction corrupts and destroys.

Daily life does require we put our trust in others, but we should do so judiciously. Each one of us has our circle of competence: performing brain surgery, hitting home runs, defending the accused in court or teaching high school math. However, doctors make mistakes and patients die, ballgames are lost on errors, innocent people go to jail and some students don't understand division. In some cases, the fault is ours, for failing to consider that the people in whom we've placed our faith are incompetent, that the supreme confidence they have in their own ability is unjustifiable.

Which leads us to the blind faith placed in our current Federal Reserve Chairman Ben Bernanke. Mr. Bernanke told us in 2006 "that house prices will probably continue to rise," and that he did "not expect significant spillovers from the subprime market to the rest of the economy or to the financial system" in 2007.¹ In 2008, he then told us that Fannie Mae and Freddie Mac were "adequately capitalized (and in) no danger of failing" and that the "Federal Reserve is not currently forecasting a recession".² And, in 2009, he said "The Federal Reserve will not monetize the debt."³ A good education, deep experience, and a nice title don't make you right. Our leaders in Washington seem to have recklessly accepted Fed decisions that threaten the delicate weave of economy and society.

Despite Mr. Bernanke's poor batting average in predicting the future, his confidence appears unshaken. He continues to speak with the same self-assurance he always has, even though what he thought wouldn't happen did, and what he thought would happen didn't. He's betting trillions of dollars that he's right – counting on an academic argument alchemizing into reality. If Mr. Bernanke were experimenting in a medical lab, instead of a monetary one, the FDA would require extensive clinical trials proving safety and efficacy before he could release his grand experiment on the American public.

Mr. Bernanke skips ahead armed with his good intentions, despite many failed prognostications, but does concede that central bankers "have been in the process of learning by doing."⁴ Perhaps, that's another way of saying, "If at first you don't succeed, try, try again." If he's wrong, our economy and possibly our society will suffer the consequences, unintended though they may be. Already, we've seen that lower rates fail to drive consumer spending, and those who are living off interest income – like retirees – either have to make do with less or accept more investment risk. And, we see bubbles beginning to form. Income hungry investors are buying bonds at the fastest pace in history, with little regard for either credit or interest rate risk.

¹ Hearing before the Committee on Financial Services, February 15, 2006; and then again, testifying at the Testimony before the Joint Economic Committee, March 28, 2007.

² Q&A after a speech to a housing and economic forum in Washington, January 10, 2008; and then remarking to the House Financial Services Committee, July 18, 2008.

³ Congressional hearing before the House Budget Committee, June 3, 2009.

⁴ In a speech at the annual Federal Reserve conference in Jackson Hole, Wyoming, August 31, 2012.

The Fed's actions embody our gradual shift from laissez-faire to government-managed capitalism. We can now work less, thanks to more expansive government subsidies, with almost 90% of our nation's tax receipts now paid directly to individuals, versus around 30% in the 1960s.⁵ And, we no longer need to depend on other countries or even our own citizens (directly anyway) to lend us money because our own government, in an accounting sleight of hand, currently lends itself the majority of the funds necessary to finance its deficits. We are a nation feeding on itself.

We need to alter our diet, and a good way to begin is to change the leadership at the Fed, where speculative thoughts have resulted in recurring and unrestrained easy monetary policies that abrogate policymakers' duties to consider what our economy will look like in ten years, rather than next quarter. The government spends what it doesn't have because it has created an easy way to borrow. Policymakers are able to avoid making hard fiscal decisions because the money is available, for now. The Fed is buying both growth and time. There's no margin of safety in its approach, and there's no Plan B.

In a Faustian bargain, we have traded the longer-term, established economic benefits of capital investment for the hope that low rates will lift asset prices to the point that consumers increase spending. Necessary investments in infrastructure, education, and intellectual property do not offer the same near term "pop" to the economy and reelection campaigns, as does the quick acting medication prescribed by our nation's leaders. As a result, our national debt inexorably rises, and yet we have purchased little in the way of sustained economic growth.

Making matters worse, return on investment –the change in GDP compared to the change in debt – has declined for decades, an argument that we have reached a Keynesian endpoint. We fear that staying the course will hasten the decline of the U.S. dollar as the world's reserve currency; continue to foster policy decisions that are convenient and easy, rather than safe and sound; ultimately slow real economic growth; further increase income inequality and possibly create either high inflation or debilitating deflation.

Although we remain unconvinced as to any one outcome, and do not expect to see the results of errant policy for a number of years, we should address the potential impact of the Fed's recklessness now. Our anxiety rises each time someone, when discussing our travails, utters the phrase, "kicking the can down the road," a metaphor that presupposes an object in the future of equal size. We envision, instead, a snowball, rolling downhill gathering girth and momentum. And, Mr. Bernanke is running behind, giving it a shove each time it comes to a plateau. With each push, given the generationally high level of debt and the historically low level of interest rates, he makes it both easier for Washington to postpone the hard decisions and more difficult for the Fed to respond in the event of another economic downturn.

We imagine it's tough and sometimes lonely to be chairman of the Fed, and don't envy anyone who takes that seat. However, we should have a chairman who operates with a better blend of ability and humility. This someone will have to take a strong stand with the public, Congress, and the President who appoints him, as there will likely be short-term pain, but we believe that will prove better than potentially disastrous consequences. John Kenneth Galbraith once described the trade-off: "Politics is

⁵ www.Research.stlouisfed.org

not the art of the impossible. It is choosing between the unpalatable and the disastrous.”⁶

At FPA, we aspire to protect capital, before seeking a return on it. We change our mind, not casually, but when presented with convincing evidence. Despite our best efforts, we are sometimes wrong. We take our mea culpa and move on, hopefully learning from our mistakes. We question our conclusions constantly. We do this with the approximately \$20 billion of client capital entrusted to us to manage, and we simply ask the same of our elected and appointed officials whom we have entrusted with trillions of dollars more.

Nobody has all the answers. Genius fails. Experts goof. Rather than blind faith, we need our leaders to admit failure, learn from it, recalibrate, and move forward with something better. Although we cannot impose our will on this Administration as to Mr. Bernanke’s continued role at the Fed, we would at least like to make our case for a Fed chairman more aware (at least publicly) of the unintended consequences of ultra easy monetary policy, and one with less hubris. As the author Malcolm Gladwell so eloquently said, “Incompetence is the disease of idiots. Overconfidence is the mistake of experts.... Incompetence irritates me. Overconfidence terrifies me.”

The discussions above represent our views at the time of this commentary and are subject to change without notice. One of our responsibilities is to communicate in an open and direct manner. Insofar as some of our opinions and comments in our letters and commentaries are based on current expectations, they are considered “forward looking statements,” which may or may not be accurate over the long term. While we believe we have a reasonable basis for our comments and we have confidence in our opinions, actual results may differ materially from those we anticipate. You can identify forward-looking statements by words such as “believe,” “expect,” “may,” “anticipate,” and other similar expressions. We cannot, however, assure future results and disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events, or otherwise.

⁶ “Ultra Easy Monetary Policy and the Law of Unintended Consequences,” William White. August 2012. Federal Reserve Bank of Dallas.