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Financial Crisis Report

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Advancing in a Time of Crisis

Words of Financial Wisdom: Knowing math does not make an engineer, any more than knowing real estate law makes an investor.

Except for the Great Depression, we are experiencing the most economically unstable period in the history of the modern world. This period will be marked with extreme fluctuations in the stock, commodity and currency markets accompanied by severe and sometimes violent social disruptions. As is typical of such times, many fortunes will be made and lost during this period. After talking with many business owners, executives, professionals and government officials from around the world, the writer believes that for the financially astute investor, this is a time of unprecedented opportunity given the global trade unbalances and distortions in the commodity and currency markets. The *Financial Crisis Report* is a free compilation of the opinions of David Miyoshi as well as of those advisors he himself subscribes to (with appropriate credits given) on how to benefit during this time of crisis. The writer receives no compensation of any kind from any advisors whose articles or ideas may appear in this report. The reader is welcomed to check on all sources of information mentioned herein. Because the opinions and observations of this writer and other advisors are provided herein without charge, the reader is asked to make his/her own judgment on the contents.

The Faulty Politics of Envy

Recently, Marie Harf, deputy spokeswoman for the U.S. State Department was quoted on MSNBC as saying "we need jobs to fight the Islamic State and terrorism." My first reaction to her statement was that this woman is totally clueless to the dire situation that lay before us. Then I realized she was espousing the standard politically correct solution to solve a social problem, be it domestic or foreign poverty or terrorism for which the Democratic Party (and some Republican Party members) are prone to espouse. But this still leaves unanswered the question why do the terrorists hate us and why is our society so polarized?

Well, back in 2012 on the *Today Show*, I think Mitt Romney hit it on the head when he said "You know, I think it's about envy. I think it's about class warfare." That year at a campaign rally in Florida, Romney sounded almost libertarian: "I believe in a merit nation, an opportunity nation where people by virtue of their education, their hard work, risk taking, and their dreams—maybe a little luck—could achieve great things."

Romney's statements reflect the basic tenets revealed in Helmut Schoeck's *Envy: A Theory of Social Behaviour*. Schoeck opens his book with:

Throughout history, in all stages of cultural development, in most languages and as members of widely differing societies, men have recognized a fundamental problem of their existence and have given it specific names: the feeling of envy and being envied.

Envy is a drive which lies at the core of man's life as a social being, and which occurs as soon as two individuals become capable of mutual comparison.

Schoeck points out that envy is destructive:

Most of the achievements which distinguish members of modern, highly developed and diversified societies from members of primitive societies—the development of civilization, in short—are the result of innumerable defeats inflicted on envy.

Equality sounds good to the naïve but is a curse to liberty and properly functioning markets. "The inequality of individuals with regard to wealth and income is an essential feature of the market economy," wrote economist Ludwig von Mises.

In his sagacious paper, "*The Confrontation with Equality in Mises and Rothbard*," Alex Pepper writes, "Not only is inequality necessary, but a conception of total equality is simply wrong … ." The fact is everyone has unequal physical and mental capabilities. Pepper continues:

Those who advocate for equality in the sense of the elimination of disparities are

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not, according to Mises and Rothbard, driven by an altruistic humanism, but rather by envy and the lust for power.

Murray Rothbard pointed out that no amount of human power could make people equal.

Rothbard argues:

The glory of the human race is the uniqueness of each individual, the fact that every person, though similar in many ways to others, possesses a completely individuated personality of his own.

It is this uniqueness that makes the division of labor, mutually beneficial exchange, and economic progress possible. These differences could lead to violence, but the market converts the uniqueness into prosperity.

Mises reminds us:

In the precapitalistic society the superior men knew no other method of utilizing their own superiority than to subdue the masses of inferior people. But under capitalism the more able and more gifted men can profit from their superiority only by serving to the best of their abilities the wishes and wants of the majority of less gifted men.

If one fails to serve customers, most of whom are certainly less talented, the punishment is a loss of wealth. Mises wrote in his book, *Human Action*, "The inequality of incomes and wealth is an inherent feature of the market economy. Its elimination would entirely destroy the market economy."

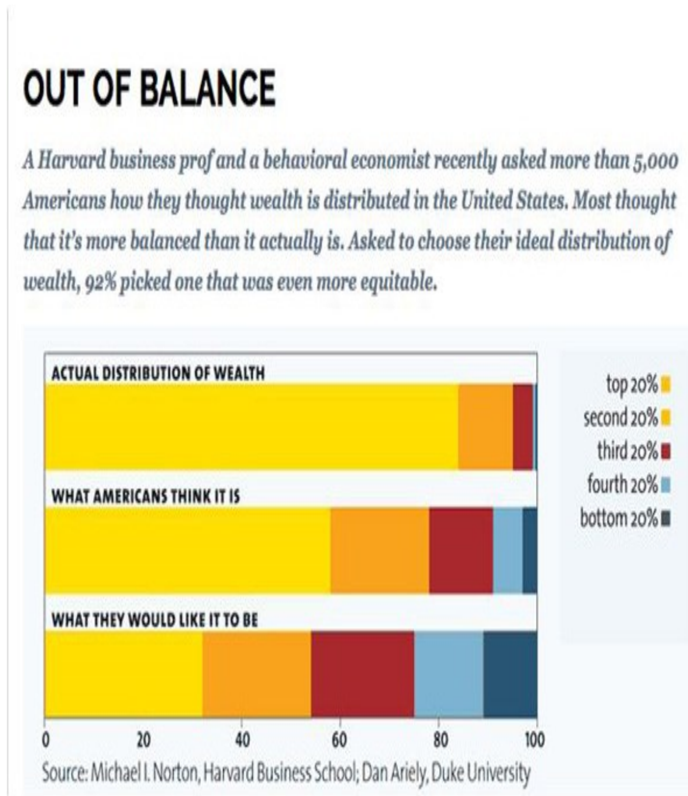
While it's still early in the 2016 presidential race, Republican candidates have adopted the income inequality canard as their primary talking point. Ted Cruz, taking a swipe at Romney, said, "Republicans are and should be the party of the 47 percent. … We should be fighting for the little guy."

Meanwhile, the *Huffington Post* writes, "Rubio argued that income inequality was simply a symptom of a larger problem: 'opportunity inequality.' He said that creating jobs is the best way to lift people out of poverty." Jeb Bush said "While the last eight years have been pretty good ones for top earners, they've been a lost decade for the rest of America."

However, inequality should be celebrated. Mises wrote:

It forces all those engaged in production to the utmost exertion in the service of the customers. It makes competition work. He who best serves the consumers profits most and accumulates riches.

He explained that luxury markets are a great proving ground for innovation and technology that eventually permeates all of society. Everything we take for granted as a necessity—smartphones, computers, flat screen TVs—were once items only the rich could afford.



The graph above shows how Americans think wealth should be distributed. However, Mises writes, "The notion of 'distribution' is itself preposterous," and Rothbard

How Do We Increase the U.S. Middle Class?

agrees, writing, “On the free market, however, there is no such thing as a separate ‘distribution’ … ‘Distribution’ is simply the result of the free exchange process.”

Americans who don’t like where wealth ends up are attacking “the subjective preferences of the consumers, not some vile process of exploitation,” writes Pepper. “The internal logic of arguments for income equality is underconsidered, erroneous, and often contradictory.”

Those who think Mark Zuckerberg has too much wealth are really criticizing the 1.35 billion people who are active users of Facebook. Think Jeff Bezos is too rich with $30.5 billion in wealth? Blame the millions of customers who use Amazon, including me and everyone I know.

Schoeck points out:

Envy’s culture-inhibiting irrationality in a society is not to be overcome by fine sentiments or altruism, but almost always by a higher level of rationality, by the recognition, for instance, that more (or something different) for the few does not necessarily mean less for the others.

America needs a return to that old-time equality. “The equality that [John] Locke and [Thomas] Jefferson speak of is equality in authority,” writes philosopher Roderick Long, “the prohibition of any ‘subordination or subjection’ of one person to another.”

To embrace the equality of Locke and Jefferson would shield us from government interventions to promote socioeconomic equality. Tragically, it’s been a long time since Thomas Jefferson was on the ballot. Today we’re stuck with the likes of Obama, Clinton and the new revised GOP.

With the social and economic strife we face domestically and with the terrorists all around us, all I can say is God Help Us.

D. Miyoshi

How Do We Increase the U.S. Middle Class?

The winner of the 2016 U.S. Presidential Election will be the one who wins the vote of the middle class.

The problem is the middle class is shrinking resulting in a marked inequality of power in our society. There seem to be two obvious approaches to reversing this trend. The government can either raise taxes on high-income earners so that funds can be redistributed in the form of tax credits or deductions to others, or lower taxes on businesses so that companies are more profitable and can afford to pay their employees more.

The problem is neither program has much chance of moving people very far up the income ladder.

In trying to bring back the middle class, we’re fighting a trend that is much larger than one administration or another. We’re trying to recreate something that was an anomaly — the 1950s and 1960s.

According to Rodney Johnson, editor of *Economy & Markets* we won’t be able to recreate it.

Johnson says this is because it’s not a domestic political issue — it is geopolitical, and rooted in global economics.

Before WWII there was a high level of inequality in our economy. As the U.S. industrialized, owners of capital did pretty well. With a steady flow of new workers moving to cities from rural areas, they could keep wages low since they could simply hire new employees if the current crop demanded more income.

Labor unions were formed to help bring about better working conditions and better benefits. The one tool that labor unions could use was the solidarity of workers to either slow down work in a factory or bring it to a complete stop. Either action would cost the business owners money.

The problem was that simply organizing labor didn’t change the facts on the ground — there were more people willing to work than there were jobs available, which kept a

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lid on wages.

The start of WWII changed all of this.

The U.S. ramped up production of war supplies ahead of December 1941, and then engaged in the war completely. Suddenly workers were scarce.

Many expected the end of the war to bring a recession, since production of war goods would stall, but it didn't happen. WWII was different. Not only had the industrial base of Europe and Japan been obliterated, but U.S. infrastructure had emerged unscathed. Suddenly, the U.S. was the provider of food and industrial goods to much of the world.

This tremendous increase in business required a lot of investment capital and a lot of workers. This gave employees the upper hand… at least for a while.

As Europe and Japan rebuilt, they slowly took business away from the U.S. By the early 1970s, Europe was back online and Japan had become a low-cost producer of goods. At the same time, the boomers hit the workforce, which added more potential employees to the economy.

This combination of adding workers and losing business to overseas markets started the downtrend in wages in the U.S. from what had been an exceptional period for workers.

The issue of rising inequality isn't about too little or too much taxation.

Raising taxes will simply drive those who can afford to avoid them further down the rabbit hole of misallocated funds as they seek out and use more loopholes.

Lowering taxes will provide more income to owners of capital, but there's little proof that this necessarily leads to workers earning more.

To change this situation, Americans will have to change the supply and demand for employees. We can make more goods and provide more services here, which would lead to more work, or we can shrink the number of people available for work.

Or even better, we can do both. Only, that's easier said than done.

If we made more goods and provided more services domestically, then Americans would have to be willing to buy them, even at a premium. It's amazing that so many people are focused on where their food comes from, but don't take the same approach when asking where their shoes, shirts, cups, watches, sheets, or anything else originated.

We all know if a car is domestic or foreign, and many goods are aspirational based on where they come from, like Swiss watches and Italian suits, but a lot of daily living goods aren't in those categories.

Unfortunately, at this point, many things aren't made in the U.S. at all, so choosing an American brand is impossible. But even if people could buy American, would they?

Would people specifically pay 10%, 20%, or even 40% more to purchase an item made domestically just to support American employment? This extra cost comes right out of family budgets, where they would have less to spend on themselves, or less to save for education or retirement.

That sounds like a hard sell.

As for changing the supply of workers, that is already happening naturally. The baby boomers are aging out of the economy. While many more boomers than their predecessors are working past age 65, the overwhelming majority of them still retire at the traditional age. As this large group exits the workforce, there will be more opportunities, and hopefully more income, for younger workers. Unfortunately, this change in the complexion of our workforce will take another 10 years to occur.

So for now, our best option is to buy American — not 100%, or even close, but a bit more than we do today — and to encourage our family, friends, peers and colleagues to do the same. This would be the quickest way to provide greater opportunities for workers, and bypass the inefficient involvement of the government.

Wish us luck.

D. Miyoshi

Why There Will Be A Financial Crisis

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This newsletter is named the *Financial Crisis Report*, so it's natural that I am often asked why and when there will be a "Financial Crisis". But the first question is much easier to answer than the second. Because there are so many variables and contingencies that are involved in the timing of any phenomenon, whether it is natural or contrived, it is very difficult to pinpoint exactly WHEN the Financial Crisis will occur. I can only say it will happen maybe next month or next decade. But my reply to WHY the financial crisis will happen is more precise.

Here is WHY the Financial Crisis will happen.

As we recall in the early 2000's central banks artificially lowered interest rates, which caused market distortions, which led banks and households to leverage themselves up, up and more up. When the housing market and mortgage securities imploded, the pain spread around the world.

But the pain wasn't all about mortgages.

It was all about "credit" in the system and how easy credit, courtesy of low interest rates, facilitated cheap financing of real estate and heavily margined and leveraged securities positions. Easy credit also aided and abetted counterparties wagering trillions of dollars on bilateral derivatives contracts that they folded up and tossed about like paper airplanes.

Confidence in the system collapsed when credit evaporated and players gave up.

The credit crisis was a global phenomenon. That's because credit stems from banks. Banks everywhere were in trouble i.e. insolvent. Central banks had to rescue them.

That's where "stimulus" came in. Zero interest rates don't matter if you're a bank with zero money to lend. So what if you can borrow from the Fed at zero interest? If there's no one borrowing from you and you can't make money by lending, you're toast.

That's where quantitative easing (QE) came in. QE was a desperate measure. Plain and simple, if you're a central bank and your banks don't have any money and you work for them, you find a way to give them money so they don't have to close down for good.

The Fed and other central banks (using different names, though the European Central Bank just went ahead and called its latest $1 trillion giveaway QE) printed money and steered it directly onto banks' balance sheets so they wouldn't be insolvent.

The Fed and the world's other central policymakers manage this balance-sheet bloating trick by buying bonds from banks. But there's no difference inside the bank if they have bonds (which are worth something) on their balance sheets that they sell for cash. It's just a switch. There's no addition to the balance sheet.

What really happens is that banks (I'm talking about big banks, the too-big-to-fail banks that all failed in the credit crisis) buy government bonds from governments that always have to roll over their debts. Sure, they pay full price for the bonds, but they don't put up the full amount. They buy them on margin.

It's done with clicks on electronic ledgers, so they don't worry about the mechanics. Anyway, central banks then buy those bonds from the banks and pay in full (credit them in full on another electronic ledger). And voila!

The Fed stuffed its big banks with more than $4 trillion. That's enough to make them not only solvent but very profitable again. And the folks in the government? They love it because they don't have to worry about selling their debt. They've got a readymade syndicate to take all they have to offer – at very low rates at that!

Bank balance-sheet bloating has been going on around the world.

And, as if not a single lesson was learned from the last credit crisis, speculators have leveraged up their "risk-on" positions because they can finance them for next to nothing.

Almost all of the big bets being made, in the tens of trillions of dollars, are front-running bets. Front-running central banks, that is.

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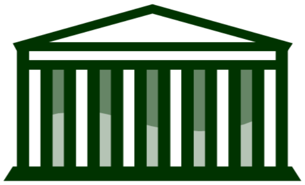

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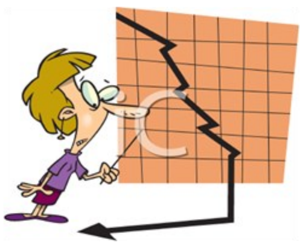

Financial Crisis Report

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He is listed in 14 Who's Who publications and specializes in international business and finance.

Take any example you like, the front-running trade works the same everywhere.

Let's take Europe, because it's the latest example of massive front-running.

Hedge funds, institutional traders, mutual funds and banks all bought the sovereign debts of beleaguered European Union member countries back in 2012. They were all paying big interest-rate spreads over better quality bonds, like U.S. Treasuries.

But when ECB President Mario Draghi famously said, "Whatever it takes," (to support the euro, the EU and its banks), the front-running began.

Buyers paid higher and higher prices for government bonds, driving their yields down to levels such as the 10-year yield on German Bunds being 0.34%; 0.57% for French bonds; 1.46% for Spanish ones; and 1.62% for Italy. And the Swiss 10-year yield is negative 0.08%.

Why so low? Because, just like in the United States, bond buyers (speculators) knew the central bank would have to come and buy their inventory from them. The ECB just announced a 1 trillion euro QE program. So, the speculators who drove up bond prices and drove down yields to insanely low levels will make a fortune selling their stockpiled government bonds to the ECB at the bloated prices they drove them up to.

That's front-running.

So somewhere, probably in Europe, maybe in Japan, maybe in Russia, banks are going to fail, probably because they loaned too much money to beleaguered oil and gas companies. Or worse, a European crisis could erupt from a Greek implosion and contagion – and then what?

After everything central banks have done to save the credit system, in the end they leveraged it up even higher with even lower interest rates.

A break anywhere in the credit system could cause contagion. If the central banks have done all they could do and are themselves leveraged well beyond being insolvent (none of them have real capital – they're all ghost lenders), confidence in the system will evaporate.

That's when the financial crisis will be upon us.

It's going to happen.

Only by immediately addressing the structural problems facing indebted countries and still shaky banks can we veer off in another direction. But the likelihood of that happening is precisely between slim and none.

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