Ark Strategic Investments

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France, the US and a Little Bit of History Repeating Itself.

January 2015. A new year. And a new window to measure the present, peer into the future and reflect upon the past. Time is an intricate topic, the muse of historians, philosophers, and even metaphysicians. Like currents, time also has its patterns, anomalies and turning points. Those who study history, respect its paradoxical ability to repeat itself yet remain unique with each era. Hence the expression: the more things change, the more they stay the same. This paradox is particularly true of the financial markets, which despite a dramatic evolution in sophistication from the first gold traders of Persia to the most recent derivative trade, share *timeless* lessons, including the notion that valuation does matter. Valuation. Whether peeling the onion of a CDO, a sovereign balance sheet, a bio-tech's P&L statement or weighing a Roman coin, understanding the *value* of something has always been essential. Once you know the value of X, for example, you can decide how to *behave* toward it. This is true not of only of asset classes, but of individuals; after all, both finance and psychology are disciplines rooted in emotions. Looking, at the intersection of time, markets, and human behavior, we see these patterns of history repeating themselves because individuals have consistently (and emotionally) misunderstood value. This misunderstanding has been played out in eerily consistent patterns of mania, denial, false-comfort and expert confirmation followed by an inevitable collapse forewarned by a minority. Today's markets are part of this history, and are dangerously—*overvalued*. The current pattern and eventual end game are set before us. In order to see this without rancor or panic, we need to at least consider history.

The history of overvalued, over-traded, and over-exuberant markets is not a new topic. Whether one looks at the Roman Empire, ancient China or modern Argentina, history repeats itself—building bubbles fueled by tulips in 1635, South Seas and Mississipi trade in 1720, land booms in the US (1835) and Prussia (1760), railroads in Germany (1845) or B2B tech platforms in the NASDAQ of 2000. Looking from the past and into the future, I (like many far brighter than me) have dedicated considerable ink to the current shape and longer term implications of our own mega bubble. Nothing in my premise has changed since 09, when the mania component of the above pattern emerged. Then, as today, I maintain that a US (as well as global) economy emboldened (i.e. supported) by trillions in fiat money printing and massive deficit creations will suffer devastating consequences. Since 09, of course, the markets have been anything but devastating—all part of the typical mania, denial and false comfort that comes from free money and a refusal to look at what we don't want to see--i.e. the fact that quadrupling the money supply, like binging on a credit card, leads to long-term pain despite its short term fun. Recapping the most recent year (2014), we saw more examples of this "fun." Markets keep rising. To those who believe in deficits without tears and printing without consequence, the score-card seems greatly in their favor, and at nearly every market peak or bullish (yet distorted) GDP or employment report, I am reminded by many of my Wall Street peers just how crazy I am. (History is equally replete with the presence of "lone nuts" chastised for calling a lame duck a lame duck when others are describing them as soaring eagles.)

Yet the historical pattern is far from over, and declaring economic victory in such a grossly QE-driven (i.e. fake) market bull is the equivalent of declaring Lance Armstrong a hero in Tours 1-7. In other words: be patient, for eventually, the obvious reveals itself in one form or another—but almost always in retrospect. There has been an abundance of post-facto pundits declaring: "Of course dotcoms were overvalued, of course housing was over-priced, of course sub-prime instruments and of course the derivatives markets were a poison." But very few experts were speaking this confidently *before* the collapses. In fact (and instead), the smartest folks in the room were consistently saying the opposite. On the verge of the greatest banking bailout in history, for example, Janet Yellin was declaring banks safer than ever in 07; an equally optimistic Alan Greenspan was cheerleading market stability minutes before the 08 disaster, itself partially unleashed by another expert, Larry Summers, who told the world (and congress) to de-regulate derivatives just before those same instruments destroyed our economy (as well as his endowment at Harvard) with nuclear-like effect. As authors like Christopher Hayes have intelligently shown: beware of the "elites." Yale's Irving Fisher, as smart as anyone in 1929, declared the stock market bullet proof a week before it tanked. Princeton's Ben Bernanke is no less intelligent, and no less capable of being wrong. The herd's faith in such elites conveniently adds to their collective need to deny real fears based on real indicators. The cry from the sheep is this: "Certainly the Fed and policy makers know better. Certainly they have our back today and know something we don't to save us." But did the elites save you in 01? In 06? In 08? Such faith in headline-making experts ignores the difference between smart and wise, for wisdom implies a humility otherwise absent from those who confuse diplomas and income with a brave common sense. (Hank Paulson made hundreds of millions before assuming the title of Treasury Secretary and was just as clueless as John Doe when the markets cratered in 08).

In fact, it doesn't require genius or high salary to see the patterns to be discussed herein. As I've written elsewhere, it requires courage—courage to step outside of the herd, to rely on your own *informed* judgment (rather than the judgment of experts) and to respect the forces of markets and history the way an old sailor respects the forces of nature, currents and waves. The economist, Peter Bernholz, studied every event of hyper-inflation since the French Revolution, and in each instance where a sovereign's annual borrowing exceeded 40% of its GDP, hyper-inflation was not far behind. *Every* time. The US crossed this 40% line in 2009. Now, at the dawn of 2015, the US Dollar is the strongest it has been in eleven years, markets are at all-time highs and reported inflation is nearly non-existent. Is the US therefore the sole exception to market history? This is unlikely. It just means history hasn't had the final say—*yet*.

I'm often told a broken watch is accurate at least twice a day, and that market bears will eventually be right—by accident. But there's no accident here. Nor bears. Just common sense, time and markets motioning perpetually toward balance, warning us again what history has taught over and over: you can't save economies by printing money, you can merely buy time and thus postpone—as well as augment—the inevitable crash.

I'm occasionally even told such pessimism is un-American. And so I turned to the most un-American example I could think of in market history to illustrate the point. In short: I looked at my beloved France. In particular, I blew the dust off an essay written in 1912 by Andrew Dickson White, the founder of Cornell University. White's book is a fascinating examination of a sincere attempt by one of the then strongest nations in the world to tackle its military, private and public debt woes through the printing of money. Sound familiar? Equally worth noting is that the French National Assembly of that era was comprised of the most intelligent minds/ experts of its era-- Matrineau, Marat, Tallyrand, Necker, Mirabeau, Bailly, DuPont de Nemours, Larochefoucauld etc. Yet even the majority of these titans of intellectual firepower and economic savvy were unable to thwart the laws of markets. As White noted, they, "like every supporter of irredeemable [i.e. fiat] paper money then or since, seemed to think that the laws of Nature had changed since previous disastrous issues." And this law of nature/markets is as simple today as it was in 18th century Paris: you can't print your way out of debt in the short-term without unleashing long-term disaster.

Reading the pages of this 1912 work, set in 1789 France and from my desk in 2015 America is a sort of journey into the surreal. One could easily change the names, venues or dates and substitute one example for another, proving indeed: "la plus ca change, la plus c'est le meme chose." That is: history repeats itself. In 1789, France, much like 2008 America, had "found itself in deep financial embarrassment." Namely, markets had crashed, deficits were growing and the population was losing faith. In this backdrop, as in 08, "there was a general search for some *short road to prosperity*" (i.e. speedy calls for the printing of money) to give the ailing nation a little boost. The French Finance Minister of the time was a fellow named Necker. Unlike our Mr. Bernanke of 2008, the Necker of 1789 recognized the short-term seduction yet long term price of printing an economy out of harm's way. He, Bergasse (of Lyon), Cazales and Maury initially sought to fight off the seductive call of free money with classical oratory at the National Assembly, proclaiming the result "could only be disastrous," as printing was nothing more than "a panacea…a way of securing resources without paying interest." They reminded others of recent history, 70 years prior, in the era of John Law when it was learned how easy it was to print money, yet how difficult it was 'to check its over-issue" and how "securely it *creates a class of debauched speculators*, the most injurious class that a nation can harbor." But against these ultimately prophetic warnings, Marat, "friend of the people" and others seduced the herd/crowds with promises of "stimulating" the economy with just the right amount of printing. Sound familiar?

And so in 1790, France made its first real toe-dip into printing money (the equivalent then of our own "QE1") with the issue of 400 million in new money (a relative hiccup compared to our 2008 equivalent in the US). The result? As expected, free money felt pretty good. The printed money was initially backed by French real estate confiscated from the nobles and the church and promised to be free of default (sort of like our apparently default-proof US Treasury). The French Treasury of 1790 was understandably relieved, debts were paid, credit was revived, trade was increased and everyone was happy—much like the post 09 "V-shaped" markets in the U.S. But, like many injections, the drug began to slowly lose its impact, and within time, the French Assembly, along with the speculators and traders from Bordeaux to Marseilles, wanted another "fix." Despite original promises by Marat to temper the printing, the addiction became too tempting, and thus another round of money was printed (a veritable "QE2" of its day) in the form of 800 millions in "assignants." The parallels to our own flirtation with printed money in post-08 America are striking. Then, as now, a small cadre tried to warn of the long-term destruction wrought by short term printing (think, today, of Stockman, Keen, the Wiedemer brothers etc.). Mirabeau, for example, spoke of the printed money as "a nursery of tyranny, corruption, and delusion; a veritable delirium…a loan to an armed robber" with inevitable dangers of inflation. But even Mirabeau got hooked on the drug of quick fixes, and later declared that "just one more round" of free money would be OK…but nothing more. As White observed: "the current toward paper money had become irresistible." Again, we have seen that same current from the Eccles building in DC as the US Central Bank evolved from the one-time 2008 "emergency injection" into a long-term drug dispenser of new money (and ZIRP) for years to come—creating and extending identical exuberance, bubbles and classes of "debauched speculators" as US markets reached record highs. As for that "mania," even the most delirious bull today cannot deny the correlation of our market rise and the rise in our money supply. As indicated above, short-term "good times" are expected components of the pattern.

This same pattern also contains the false comfort of experts whose bullish rhetoric keeps the herd marching obliviously, even comfortably, toward cliffs. The France of the 1790's didn't have CNBC or the Private Wealth Management teams of Morgan Stanley et al, but they had even more talented orators at the assembly. One, a certain Monsieur Gouy, even suggested the French simply liquidate its entire national debt by printing a large amount of money to be used, in his own words, to solve the nation's problems, "by one single operation, grand, simple, magnificent." These were of course comforting and tempting words. Followed by pamphlets and more brilliant speeches appealing to stimulating the economy and offering dashing projections of how printed money leads to growth and prosperity. Sound familiar? And these were the words of men like Talleyrand and Mirabeau—certainly no less bright in IQ than anyone on Fox, CNBC or the FOMC. But as Andrew White noted in 1912, smart people don't necessarily understand monetary policy, and calling upon experts just because they show boldness and optimism "was like summoning a prize fighter to mend a watch."

Then, as now, there were lone voices of dissent, even exasperation. Necker, the Finance Minister, ultimately resigned in frustration. Economists like Maury attempted in vain to illustrate how the first issues of printed money always bring prosperity, but "those that follow bring only misery." Le Brun attacked the whole scheme in the Assembly, prophetically declaring "that the proposal, instead of relieving the nation, would wreck it." Boislandry, Du Pont de Nemours and others published pamphlets, presenting with haunting accuracy "that doubling the quantity of money simply increases prices, disturbs values, alarms capital, diminishes legitimate enterprise and so decreases real rather than speculative demand that the only persons helped by it are the rich who have large debts to pay." Stated in 1790, but no less true in 2015.

Then as now, such warnings and calls for restraint were not as popular as those promising continued prosperity, free money and, as one expert declared with a confidence foreshadowing Irving Fisher or Larry Summers, "the end of further concern." France, like the US today, was thus fully committed to a policy of inflation and delusion. Again, and for a while, the economy moved along, even prospered. White observed, "that the great majority of Frenchmen now became desperate optimists, declaring that printing is prosperity….The nation was becoming inebriated with printed money." Such observations remind me of an S&P that never seems to stumble, a DOW hitting all-time highs and a bond-market which defies all laws of risk because of the short-term safety net of modern QE and ZIRP. But the party can't last forever; those nets are full of weak-spots. Now as then, "troublesome cracks" have begun to appear. As White noted of France, "soon the markets were glutted and demand began to diminish." In other words, bubbles were approaching their apex and the natural forces of market cleansing were approaching. Panic set in. Solution? Print more money! And thus the French, like the FED's QE3, went back to the printing press. By 1791, hundreds of millions more were printed. And "out of this easy money came speculating and gambling and luxury, and out of this, corruption, which grew as naturally as a fungus on a muck heap. It was first felt in business operations and markets, but soon began to be seen in the legislative body and in journalism." Sound familiar? Today, market journalism is less a reporting of facts, but more a pulpit for market making salesmanship bordering upon propaganda. (Employment, earnings, gold and inflation statistics, for example, are flatly manipulated or engineered out of context to create misleading signals. This is not part of some "conspiracy," but rather par for the course behavior in an industry that thrives on buy rather than sell orders). Then, as today, a corruptive luxury was enjoyed by bankers and expert market consultants whose incomes were entirely incongruent with their actual value. In 2008, for example, had the natural laws of markets been left free of money printing and FED intervention, the majority of those very same bankers and experts would be *au chomage...*

But as for the mania in France then, and the current mania in US markets today, the ending is the same. It all came crashing down in dramatic fashion. We have no guillotine in 2015, but heads will roll in one metaphorical way or another soon enough. The lesson of 18th century France (or subsequent collapses in Germany, Poland, Brazil, Bolivia etc.) is that the party comes to an abrupt end once artificially paid-for markets run out of steam. You cannot massively and simultaneously print money and increase debt without grossly distorting markets, no matter how long (or "fun") the delay. Eventually, the printed money inflates asset classes while deflating real economies. The bubbles pop. Markets collapse. The evidence today is ample enough, but the collective courage to look at it is temporarily lacking. At some point, however, faith in the print/debt experiment will be too hard to sustain. Events will trigger a collective panic, as nothing sustains our inflated currency today but a misguided faith in it. In the interim, it is normal for humans to ignore questions whose answers are upsetting. For those still reading this, "viewer discretion is therefore advised." Just consider the following cold realities, which serve as a kind of highlight reel of years repeating myself:

- Since 2008, the US has increased the money supply by 4X, printing more money in seven years than was created in the previous century, combined;
- In the same period, the US has nearly doubled its debt levels to almost $18T; when we include un-funded liabilities to the balance sheet, the number is $200T. The pre-08 ratio of debt to capital of the US Central Bank was 22:1; today its 77:1. Bubbles are *always* and everywhere fed by debt/easy credit. The greater the credit preceding the bubble, the

greater the "pop." Current global debt levels are the highest in history; just follow the algebra;

- In that same period of excessive printing and debt creation, actual GDP growth has been anemic. For every dollar of sovereign debt created, the US sees 3 pennies worth of growth;
- US employment is at depression levels; despite reporting tricks, the actual percentage of the working age population that is in fact employed (including part-time work) is 59%. When positive reports highlight declining unemployment rates, they conveniently omit the millions of individuals who have simply given up and left the labor force. 50 million Americans are on food stamps today;
- Despite Main Street's woes, Wall Street speculation has singularly benefited from QE sustained markets (equity, bond, currency) which are in fact bubbles of unprecedented size poised for eventual collapse. The correlation of QE announcements (i.e. money printing) and S&P peaks is 1:1. Meanwhile, five of the six "too big to fail" private banks have exploited the recent US ZIRP policies and are more levered today than during their pre-08 excess. They share $40T in derivative exposure; today, for each dollar of economic growth, there's 30 dollars of bank debt (a 30:1 ratio; in 1980 that ratio was 2:1);
- At $710T, the Current notional value of derivatives (i.e. levered paper) trading in global markets equals 10 X global GDP. The current ratio of stock market capitalization to GDP is a bewildering 203%. (In 1929 the pre-crash ratio was 84%.) These numbers defy reason and, as complexity theory suggests, are beyond the measure of even the most sophisticated risk management systems.

In other words, having printed more money than any time in history and having surpassed record-breaking debt levels, all we have to show for this staggering monetary experiment is higher unemployment, weak GDP growth, inflated stock/bond and currency markets and an historically unmatched and over-levered central and private banking system. These facts point to a higher excess than anything seen in 1790 France or even 1929 America, and yet the majority of investors today still think we are in a recovery. We are not. We are in a cycle. A bubble. And it will end badly.

Does this make me or my colleagues bears? Are we hiding in caves? Shorting markets and hoarding precious metals? No. In fact, we are more optimistic than ever, as more opportunities and returns are made during crashes than rallies. For those who understand history as well as market indicators, there are sound, though hardly perfect, mechanisms for navigating and benefiting from bubble creations and bubble destructions. The real money will indeed be made after the "pop," but there's no point in fighting the Fed; the key is not failing with it. This requires some timing risk, but even that risk is nothing compared to ignoring the bubble patterns outlined above and elsewhere. We write these paragraphs (as well as best-selling books) not to be negative, but to be informative. As always, each reader can make their own conclusions. That, after all, is a purely individual sign of courage.