

Discovery Investing in a New World

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Powering America

- How did we get into this mess?
- More than 1/4 of the US \$15 trillion national debt and yearly deficits has accrued from importing foreign energy and fighting foreign energy wars

Impact of Energy Dependence

- In 2010, the total U.S. trade deficit was \$497.9 billion. This was \$1.8 trillion in exports minus \$2.3 trillion in imports.
- America's dependence on foreign oil drives the trade deficit. In 2010, the U.S. imported \$252 billion in petroleum-related products, compared to \$188 billion in 2009.

Impotence of Political Policy Regarding Energy and the National Debt

- In 1973 the United States imported 34.8 % of its oil from foreign countries.
- “Our independence will depend on maintaining and achieving self-sufficiency in energy,”
President Nixon
- In 1979, imports were up to 45 % of the nation’s oil supply .
- “the country will never again use more foreign oil than we did in 1977.” President Carter
- By 1990 at the dawn of the Persian Gulf War the United States imported 42.2 % of its oil.
- “reverse excessive dependence on foreign oil” President George H.W. Bush
- By the time his son ran for office, sport utility vehicles ruled the roads and 52.9 % of the nation’s petroleum came from overseas.

- By 2006, when President Bush declared in his State of the Union that the nation was “addicted to oil,” foreign countries were delivering 59.9 %.

Canada's Unique Role

- Largest energy exporter to the US
- Oil “tar” Sands
- Pipeline controversy
- China

Irving Fisher's Innovative View of Debt and Deflation

In a seminal article in 1933, Mr. Irving Fisher offered a very different and innovative view.

He focused on the meltdown of financial markets, the devastating effects of a downward spiral connecting the

deflation of assets and goods prices,

**the deleveraging by households and firms, and
contraction of economic activity.**

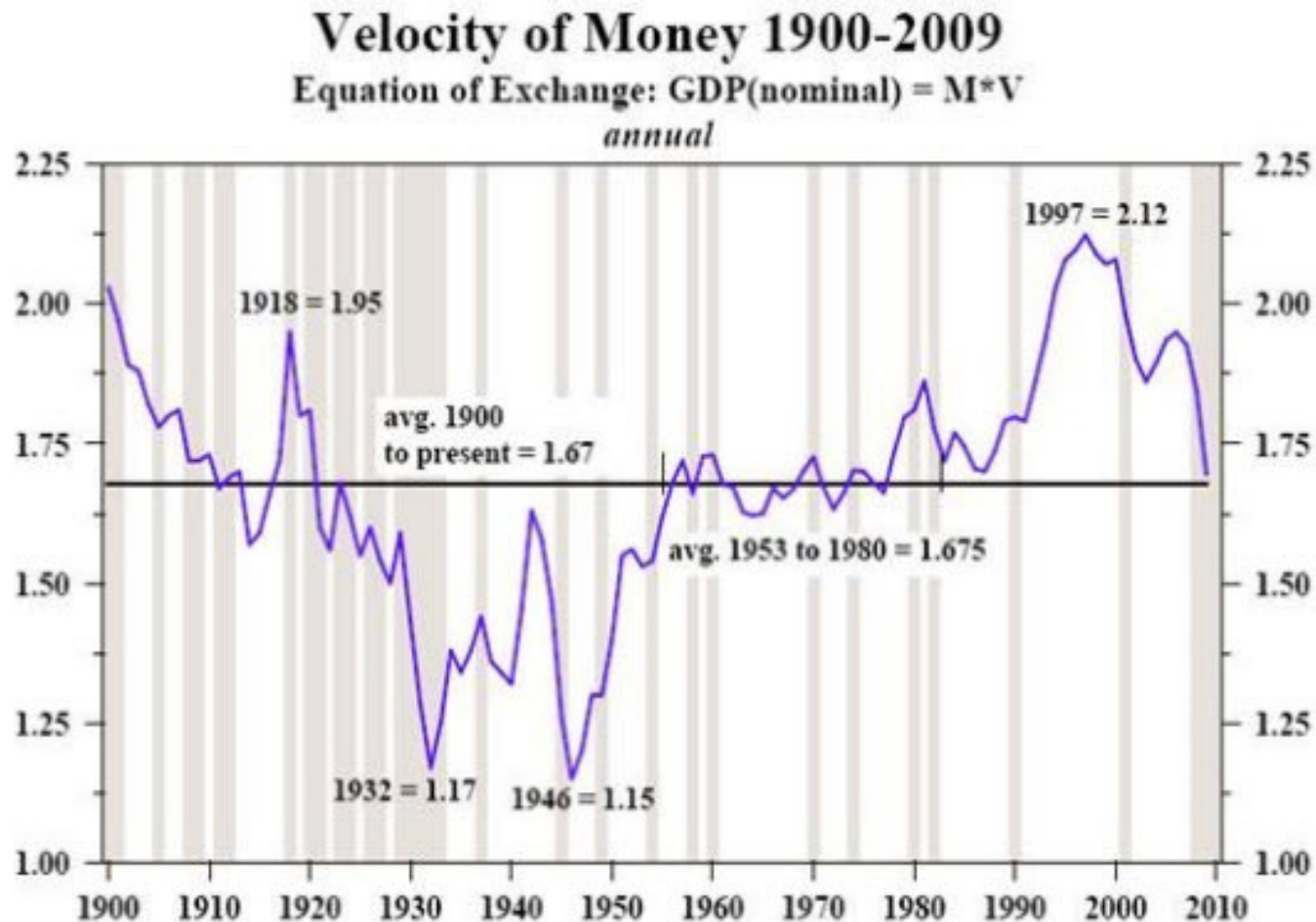
Indebtedness



Velocity of Money

The rate at which the money supply turns over relative to the GDP

$$GDP = M * V$$



Sources: Federal Reserve Board; Bureau of Economic Analysis;
Bureau of the Census; Monetary Statistics of the United States. Through 2008.
2009; $V = GDP/M$, $GDP = 14.3$ tril, $M2 = 8.4$ tril, $V = 1.69$

A Slowdown in Velocity

Why Is The Velocity Of Money Slowing Down: Growth in M2 was falling during most of the period, yet the economy was growing. That means that velocity should have risen faster than normal. Primarily because of the financial innovations introduced in the early '90s, CDOs, etc. *It's financial innovation that spurs above-trend growth in velocity.*

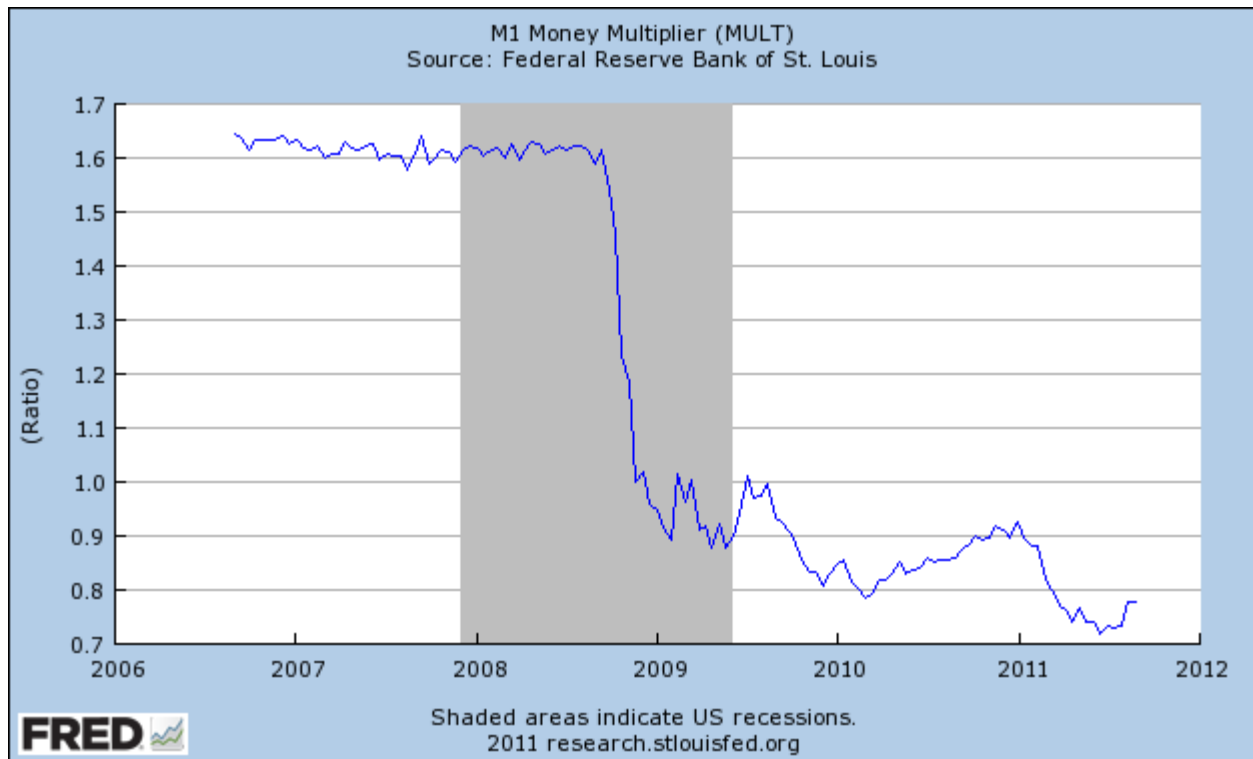
Watching The Great Unwind Of Financial Innovations: Pursued to excess they caused a credit crisis. In the beginning CDO's were a good thing. But standards got loose, greed kicked in, and Wall Street began to game the system.

The Financial Innovation Drove Velocity To New High: If the money supply hadn't risen significantly to offset that slowdown in velocity, the economy would have been in a deep recession or depression. When the Fed lowers interest rates it's supposed to make us want to take on more risk, borrow money, and boost the economy.

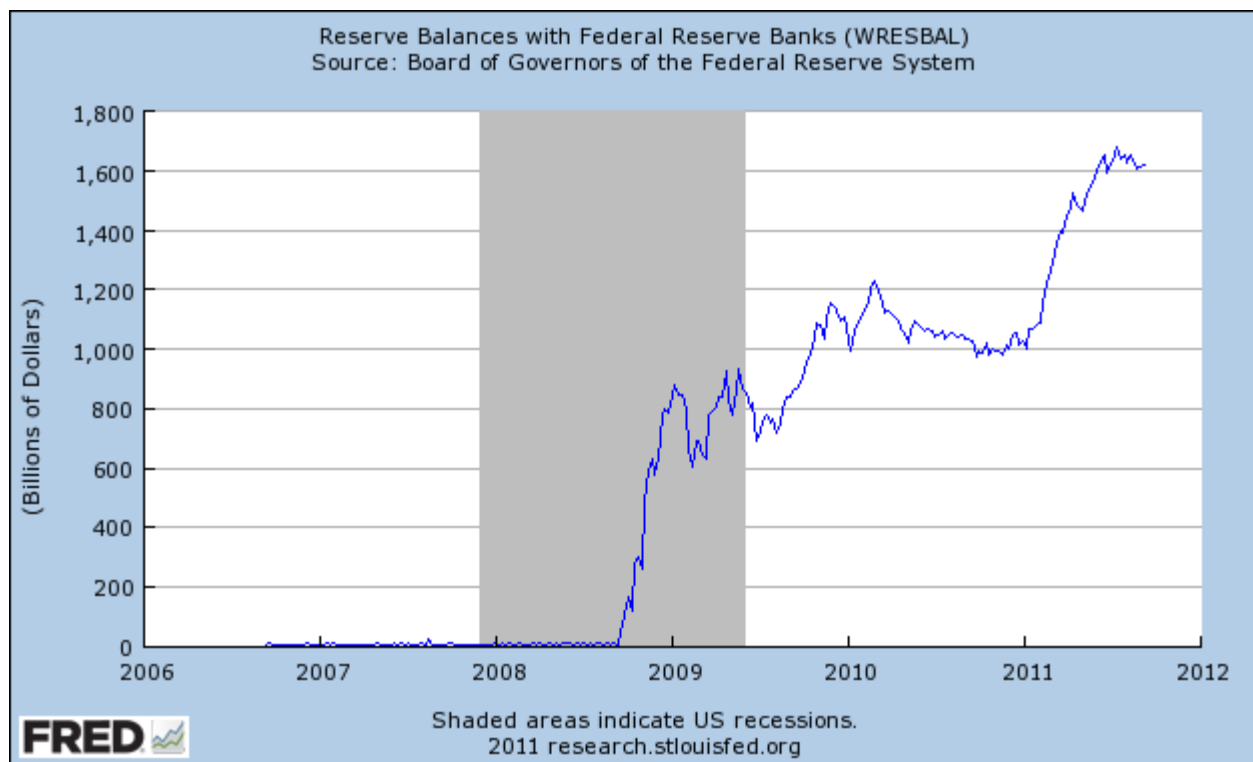
Policy Conundrum For The Fed: They've pumped a great deal of liquidity into the economy. Normally, banks would take that money and multiply it by lending it increasing velocity and the overall money supply

But today bank lending is still falling at an average of 15% annually, so far this year. But what if that trend stops?

St Louis Fed- Money Multiplier Through August 2011

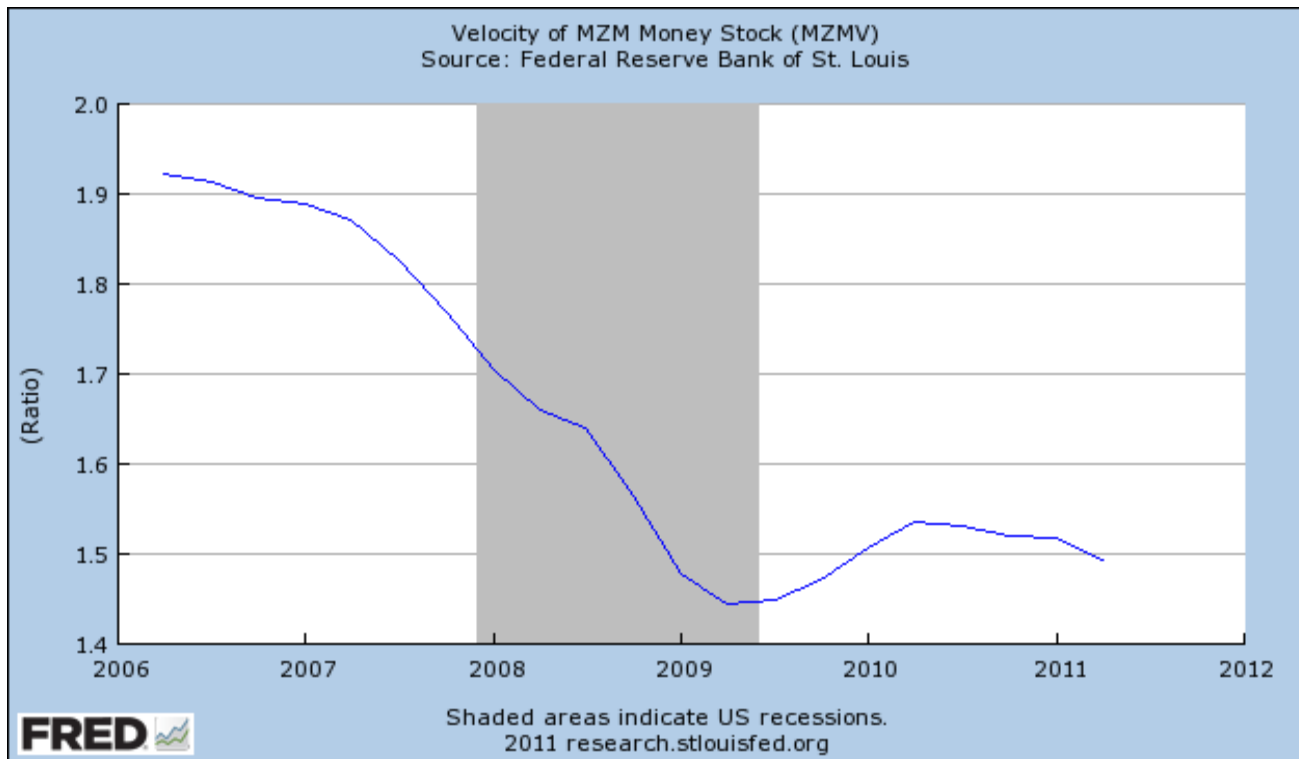


St Louis Fed- Reserve Balances of Banks Held by the Fed Through Sept 7 2011



St Louis Fed - Velocity of Money MZM

(Money Zero Maturity)Through June 2011



Economic Reality Beyond the Market and GDP

More than five million homeowners are behind on their mortgages.

There are over six million Americans who have been unemployed for at least six months, a record 40% of the ranks of the jobless

The private capital stock is growing at its slowest rate in nearly two decades.

Roughly 30% of manufacturing capacity is sitting idle.

Nearly 19 million residential housing units, or about 15% of the stock, is vacant.

One in six Americans is either unemployed or underemployed.

David Rosenberg of
Gluskin Sheff.

Economic Reality Beyond the Capital Market and GDP

Commercial real estate values are down 30% over the past few years

Bank credit is contracting at an unprecedented 15% annual rate so far this year as lenders sit on a record \$1.3 trillion of cash.

Unit labor costs are down an unprecedented 4.7% over the past year, and what has replenished household coffers has been the federal government, as *transfer payments from Uncle Sam now make up a record 18% of personal income* (and the Senate just passed yet another jobless benefit extension bill!).

The average American worker has seen his/her level of wealth plunge \$100,000 over the last 3 years, even with the recovery in equity markets this past year.

Competing Economic Theories and Solution Sets

- Keynesian – inflate out , print and spend
- Monetarist – govern the money supply
- Austrian School - free market
- Classical – Debt Deflation necessary and sufficient
- All provide different descriptions of the economic and political dynamics surrounding the world and they offer different solutions

The World Is Slowing

- Real Estate
- Sovereign Debt defaults
- Cost push inflation
- Negative real rates
- Increasing global imbalances

The Deflation /Inflation Paradox Revealed

Irving Fisher's Debt Deflation Model

According to the debt deflation theory, a sequence of effects of the debt bubble bursting occurs:

- Debt liquidation and distress selling.
- Contraction of the money supply as bank loans are paid off.
- A fall in the level of asset prices.
- A still greater fall in the net worth of businesses, precipitating bankruptcies.
- A fall in profits.
- A reduction in output, in trade and in employment.
- Pessimism and loss of confidence.
- Hoarding of money.
- A fall in nominal interest rates and a rise in deflation adjusted interest rates.

Debt Liquidation And Distress Selling.

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Current Lessons from the New Economics

- **Lesson 1:** Fiscal stimulus is a band-aid. It may be necessary but it is clearly not sufficient.

Lessons

- **Lesson 2:** Deflation must be halted and reversed, and the credit system restarted.
- Deflation will not stop if the collapse of the credit system is not contained, and the collapse of the credit system will not stop until the deflation of asset and goods prices is controlled.
- A trillion dollars of fiscal stimulus today will not avoid catastrophe if the financial stabilization fails.

- **Lesson 3: Prevention.** We got into this mess because financial development advanced ahead of regulators, government officials, and actors in financial markets, including geniuses who created innovative financial products such as CDOs, MBSs, CMOs, and the greatest villain of all, CDSs

Fisher's Hope

- *“Finally, I would emphasize the important corollary, of the debt-deflation theory, that great depressions are curable and preventable through reflation and stabilisation*

Deflation and Hyperinflation - Can't Happen here? Think Again

- US 1873 -1896
- China 1933 - 1945
- Germany 1920 -1932
- The US 1980 – almost
- Global 2007-2011 ???????