# *The More Things Change...*

## Perpetual Maladjustment

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Federal Reserve chairman Janet Yellen makes no apologies for raising the prices of stocks and bonds. It's all for the little people, she says. "We are trying help families afford things." What her employer really does is allow the bankrupt to keep operating.

Dr. Yellen claimed in a speech this spring, "Although we work through the financial markets, our goal is to help Main Street, not Wall Street." No doubt those who work at the corner of Wall and Broad, and reside in luxurious Greenwich smiled when they heard the chairman's comments. After all, the top ten percent of wealthy Americans now earn more than half the country's total income for the first time.

Securities prices soar with Fed's interest rate manipulation while the U.S. economy remains sour. Low rates haven't provided the cure. Perhaps, as Thorsten Polleit wrote on mises.org, the Fed's low interest rate cure is in fact the disease.

The new Federal Reserve didn't intervene when the economy plunged in 1920. Keynes had not yet penned *The General Theory*. Wages and wholesale price levels were left to crash.

The Fed's chairman was William P.G. Harding, a banker of all things, from Alabama of all places. He and the Board of Governors, in response to deflation, *raised* interest rates. The result, wrote Benjamin Anderson in *Economics and the Public Welfare* was: "In 1920-21, we took our losses, we readjusted our financial structure, we endured our depression, and in August 1921, we started up again. By the spring of 1923, we had reached new highs in industrial production and we had labor shortages in many lines."

Bankers don't direct the central bank anymore; it's a job for PhDs. Since Arthur Burns took the chairmanship during the Nixon administration, central banking has become macroeconomic central planning. Gone are the days of merely facilitating the banking system's seasonal liquidity needs. Ostensibly, job one is increased employment via money creation and lower interest rates. If big banks, auto companies, home builders, and government entities are saved from extinction the Fed figures its all the better.

Nobody remembers Mr. Harding and his quick solution to the 1920-21 depression. Fed chairman are now considered either the most, or second most, powerful person in the western world. Chairman Greenspan was knighted by the Queen and Ben Bernanke was Time's Person of the Year. Some are already calling Dr. Yellen the most qualified Fed Chairman ever. The more a chairman attracts fame, if not fortune, for their tinkering, the more the economy suffers.

What Dr. Yellen and her predecessors miss is the role interest rates play in providing signals to the marketplace and directing capital to its most efficient uses. With laissez faire capital flows to entrepreneurs investing in economic projects that in turn require labor. We don't know what jobs will be created, that will be dictated by consumer preferences.

The modern Fed cannot bring itself to do nothing. The Keynesians at the Fed think, as F.A. Hayek said in his Nobel acceptance speech, there "exists a simple positive correlation between total employment and the size of the aggregate demand for goods and services; it leads to the belief that we can permanently assure full employment by maintaining total money expenditure at an appropriate level." Hayek said he regarded this belief "as fundamentally false, and to act upon it, as we now experience, as very harmful."

This December it will be 40 years since Hayek told the economics profession as he accepted its highest honor, "We have indeed at the moment little cause for pride: as a profession we have made a mess of things."

The only Austrian Nobelist didn't live long enough to see a real mess of things.

These Fed-manipulated low interest rates keep the bankrupt--be it companies or governments--operating beyond their natural lives. These entities are preserved to continue wasting capital. Artificially low rates not only allow the inefficient to stay in business, but divert capital away from better operators.

Cash flow goes to service debt at the expense of making adjustments and investments to satisfy changing consumer demand. These entities will not rehabilitate, in fact, low market rates signal to them that they don't have to. Low interest rates signal lower risk and tell the borrower he or she is functioning efficiently when in fact that's not the case. Left to the market, interest rates will clearly differentiate the creditworthy from the bankrupt. When the Fed forces rates down, this distinction is blurred.

Ultimately, precious capital is squandered in the process as jobs are lost or not created in the first place. Businesses that weren't meeting consumer needs are kept in business while new entrepreneurs are excluded from

managing these assets more efficiently.

Writing for the *Cato Journal* in 1986, professor Roger Garrison explained the individual elements of what he termed the Hayekian Trade Cycle Theory. Prices "convey essential information to each market participant," Garrison writes. These signals "provide the basis for economic coordination; price signals falsified by monetary manipulation create a basis for economic discoordination."

Interest rates dictate the total amount of investment and also the "pattern of investment." Lower rates encourage investment in the future. A central bank produced credit expansion "whets the appetite of producers causing them--collectively--to bite off more than they can chew," Garrison explains, taking on projects that can't be completed.

Low rates also encourage governments to expand budgets, pensions, and services to buy votes, biting off more than they could ever chew.

For instance, Greece, a country that restructured €200 billion in outstanding bonds to avert an economic meltdown two years ago, was able to issue bonds at yields below five percent in April, a fraction of the over 30 percent yields Greek bonds traded for in the crisis.

Puerto Rico, a territory that has been in recession for eight years, an unemployment rate exceeding 15 percent, with half the population living in poverty was able to float a record amount of debt earlier this year.

The country hasn't been able to make ends meet for more than a decade and owes about $87 billion including pension obligations. Yet, the municipal bond market is off to a great start according to Bloomberg, "as Puerto Rico's record $3.5 billion junk deal leaves demand for higher-yielding securities unslaked."

Less than financial powerhouses, Italy and Spain, are now borrowing ten-year money for just over three percent, not much more than the United States and Germany. The U.S. government itself is less than creditworthy, being the largest debtor in the history of the world. Last year, 71 percent of its new bond issuance was purchased by the Federal Reserve, yet, for the moment, it borrows at miniscule interest rates.

In the corporate debt world, "Investors Clamor for Risky Debt Offerings," announced the Wall Street Journal headline earlier this year. Investors put almost $3.5 billion in taxable high-yield bond funds and ETFs in the first quarter of 2014. "We're in an environment where the discerning eye of real credit investors has given in to the less discerning generic yield grab," Stuart Lippman, a portfolio manager at TIG Advisors LLC, told the WSJ.

Junk yield premiums have fallen to 5.4 percentage points, the lowest since 2007 and bond covenants are reflecting a borrower's market. "The Moody's Investors Service covenant-quality index, which rates high-yield bonds for investor protections, with 1 the highest score and 5 the lowest, fell to 4.14 in March from 4.05 in February," reports the WSJ.

Loose borrowing covenants and low yields have not dissuaded investors. According to the Bank of America Merrill Lynch Global High Yield Index the market for speculative-grade debt (junk) was near $2 trillion in April. The index began in 1997 and didn't reach $1 trillion in total value until 2009. Only five years later junk bond totals have doubled.

While speculative debt quantities explode, the quality deteriorates. "*For the first time ever*," The Elliott Wave Financial Forecast April edition pointed out, "two thirds of U.S. leveraged loans are covenant lite--loans with more liberal limits on collateral, payment terms and borrowers' income levels--

compared to just 29% reached at the height of the leveraged buyout boom in 2007."

Grant's Interest Rate Observer provided chapter and verse on the disconnect between risk and yield in its April 4th edition. Grant's mentioned the debt of casino operator Isle of Capri trading to yield just 5.50 percent, despite the company not generating enough operating income to cover interest.

Professor Garrison explained artificially low interest rates create intertemporal disruption with longer term projects financed at the expense of later stage goods. However, market participants are unaware of what effects monetary intervention has had on inputs. "Resources can be profitably misallocated in response to a distorted price so long as the resources are sold before the bust."

Investors in junk bonds must hope to sell before the inevitable crash. "After a protracted period of monetary manipulation," Garrison writes "the economy may well find itself considerably off course. The ensuing readjustments would confirm in the large--if not the small--to those that Hayek originally envisioned."

The economy on Main Street is certainly off course, while Wall Street lives in the Fed's lap of low interest luxury. Back in 1932, three years into another depression, the Nobel prize winner wrote in an essay included in *Hayek's Triangles: Two Essays On The Business Cycles*, "But, instead of furthering the inevitable liquidation of the maladjustments brought about by the boom during the last three years, all conceivable means have been used to prevent that readjustment from taking place; and one of these means, which has been repeatedly tried through without success, from the earliest to the most recent stages of depression, has been this deliberate policy of credit expansion."

The central bank forgot what it knew in 1921; to stand aside and let the market clear. Until modern central bankers heed that lesson and let maladjustments be liquidated, true recovery, and employment will have to wait.

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