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THE VALUE VORTEX – *Why Value is Getting Harder to Find!*

MACRO INSIGHTS

Gordon T Long
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HIDDEN AGENDAS – *Coming Out of Hiding!*

The last two months I have talked about a potential recession, minimally seeing a US Earnings Recession or what I will call a Consumer Recession.

Today I want to talk about what the government is doing to prepare for this possibility.

What bullets do they have when rates are already zero after 6 years? We normally have 4-5% points to use as economic stimulus.

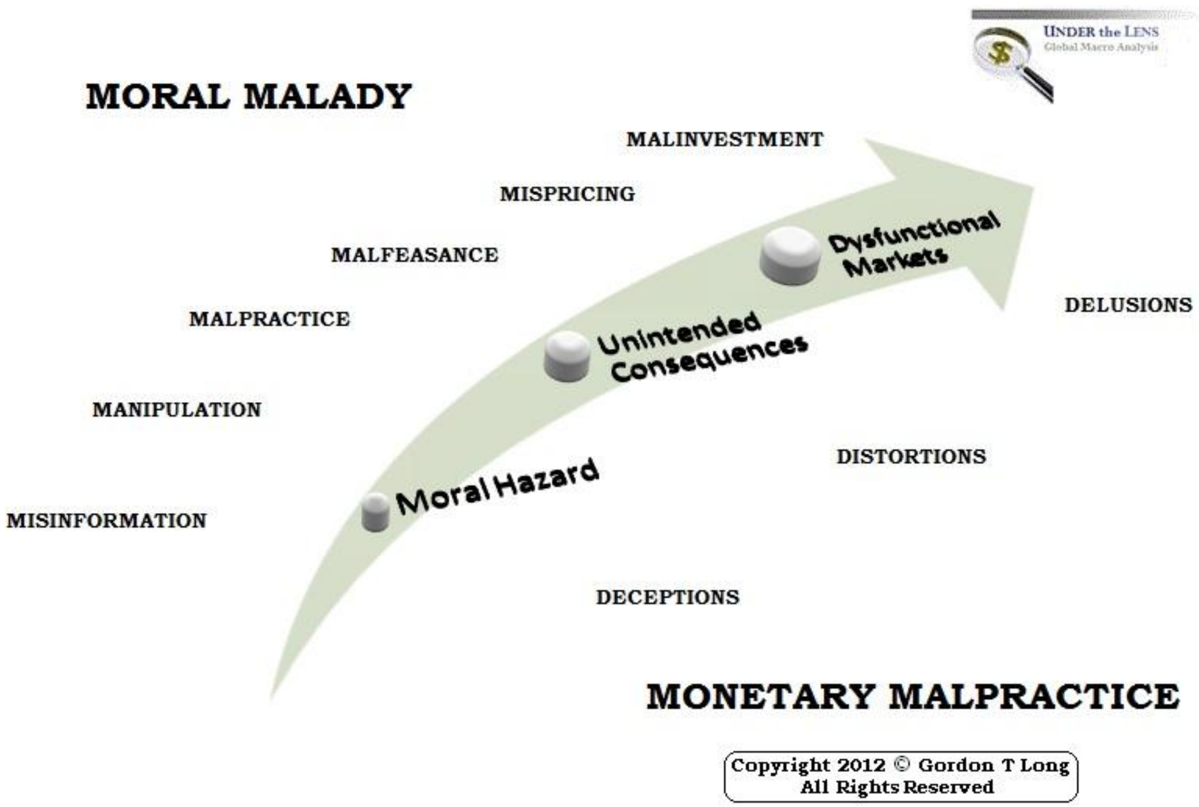
What are the planners going to do?

They are already sending clear signals and putting out trial balloons in preparation.

MONETARY MALPRACTICE

Over the past 3 years we have shown this roadmap many times of what we saw evolving regarding what could only be regarded as Monetary Malpractice.

Each of the steps labeled in the diagram we backed up with endless examples as they unfolded.



In this month's GMTP I want to take a slightly different view of what these monetary policy decisions are inevitably leading us towards.

MONETARY VORTEX

UNSOUND MONEY

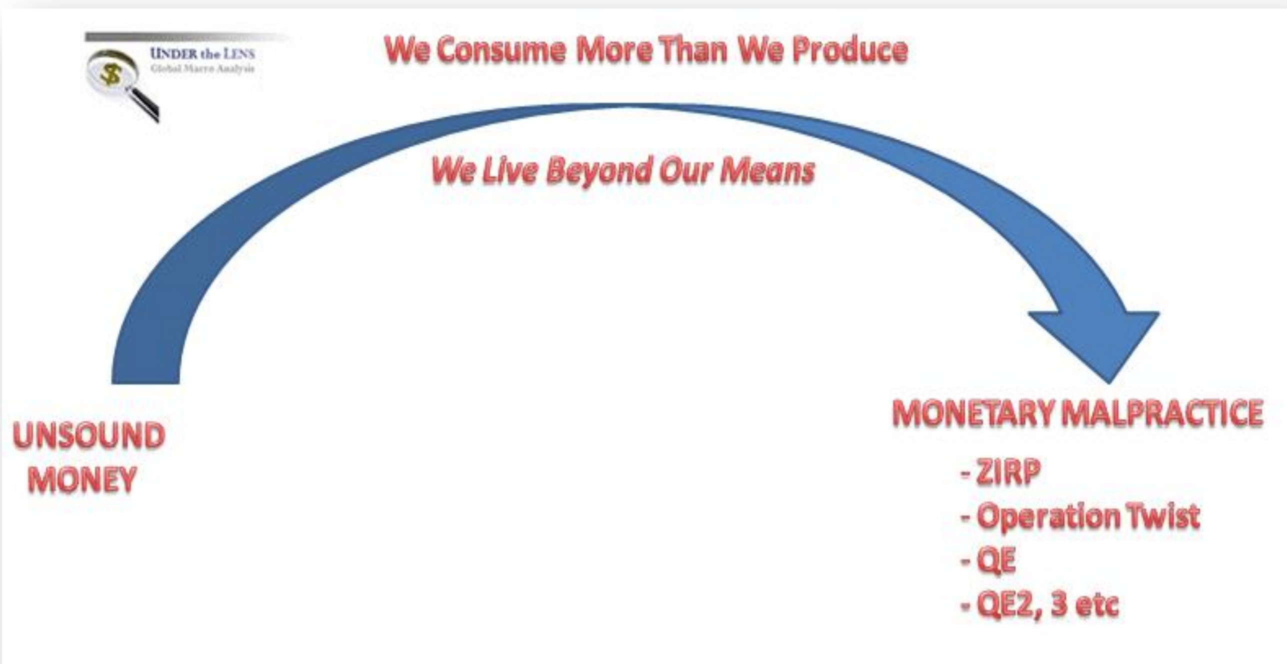
When a family lives beyond its means by consuming more than it produces we all know what happens.

Bankruptcy, repossession of assets by creditors destroyed credit and more. What is important is to understand is that it is actually different for sovereign nations. That is because they control the currency or money.

Similarly to any family caught in a position of not being able to meet its obligations sovereign governments are forced to make choices it has avoided through irresponsibility.

Governments choices are different however. They almost always adopt policies of unsound money through Monetary & Fiscal Policy frameworks. We won't talk here about the fiscal games such as "Cash-for-Clunkers" or "HAMP" etc. Instead from a monetary perspective we have what has been labeled as Monetary experiments such as ZIRP, Quantitative Easing (QE), Operation Twist etc.

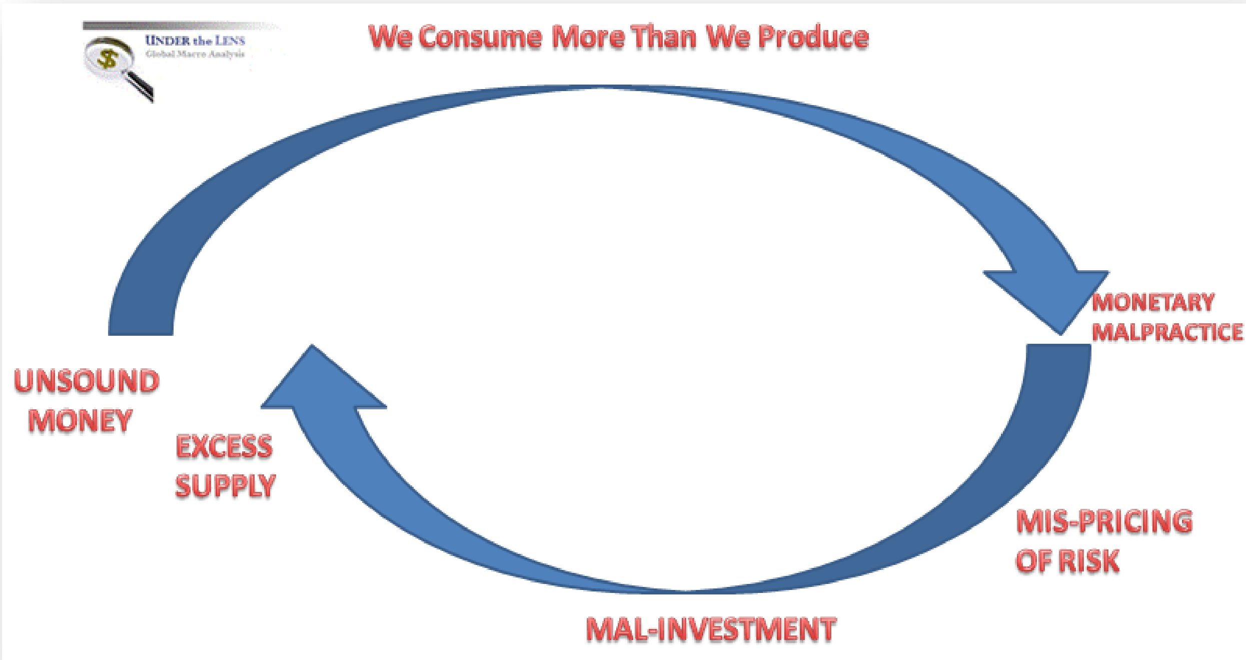
All of these policies keep the cost of the debt obligations by the government at ridiculously low levels under the cover of "stimulating" the economy. By doing this it is robbing savers and pensioners of the income on their savings to allow the government to maintain its prolific and irresponsible spending.



If this charade is allowed to go on too long without correction, very serious consequences and changes in the economy begin to occur.

EXCESS SUPPLY

When rates are artificially held low we get the mis-pricing of risk. Debt in the form of bonds, whether IG, HY or sovereign all trade at levels not reflecting their underlying risk. Low yields mean high bond prices which means they are worth more as collateral which can be used for further borrowing. Mispricing in the debt market is far more serious than overpricing or mispriced stock prices. The whole bases of lending and the capitalist system is distorted.



Mis-pricing of risk quickly results in mal-investments. Businesses that have no basis for existing on fundamentals such as free discounted cash flow suddenly get funding because money is readily available which must be placed by yield hungry lenders.

Business can expand to chase markets they weren't previously able to go after. The result is an inevitable over supply of everything. The market share objectives of all the competitors soon add up to multiples of the 100% market share actually available. Rather than business failures we have them refinanced through roll-overs so they can have time to get customers. Price quickly becomes their only recourse to fight with in an overcrowded market.

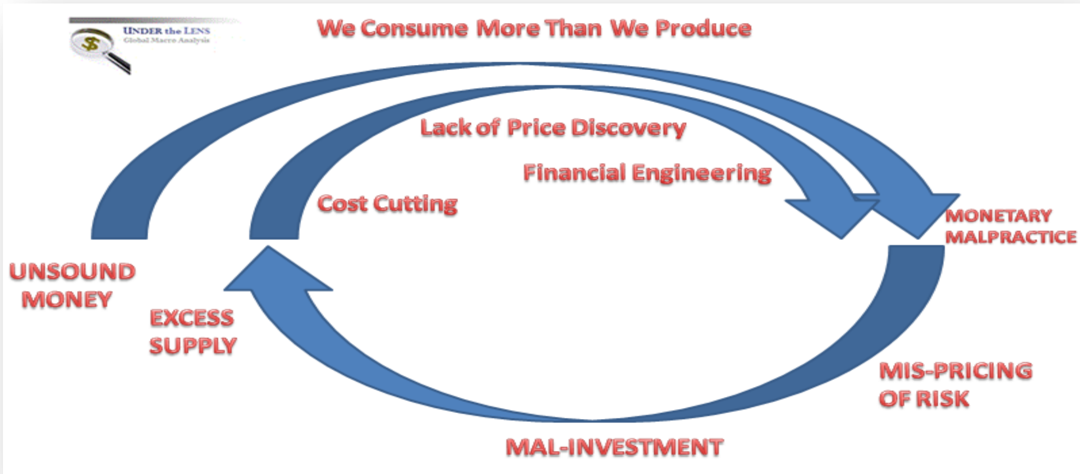
FINANCIAL ENGINEERING

When price becomes the key to competitive advantage then cost cutting becomes paramount. Cost cutting becomes a matter of short term survival.

Competitive pricing also leads to a lack of price discovery on asset values as discounting, promotions, false pricing etc all begin to occur.

When you can't make top line sales and margins are a problem it forces you to use Financial Engineering to keep the business alive. 95% of all S&P 500 companies are currently employing buybacks and dividends to make bottom line EPS and yield look better.

Without this the business is subject to being taken over and stripped of any valuable assets and potentially loaded up with more debt as the game continues based on basically free, tax deductible debt. As bonds trade at negative nominal rates the incentives to take on debt for financial engineering are simply irresistible.



USAGE – LACK OF INVESTMENT, LACK OF LENDING

The smart money and bankers quickly see what is going on. Investment stalls, corporations stop spending on Capital investments, for the sake of using cash for Financial Engineering. Banks don't want to lend because they can't find sound collateral and business that cannot sustain free cash flows unless money is permanently cheap.

This is one reason we have well over $2T is excess reserves by the banks held at the Federal Reserve. It isn't that they don't want to lend. It is a matter of those who want to borrow are not sound lending risks. Those who have sound businesses don't want to invest capex and borrow to do it. These companies must use their cash to keep their stock price up (though buybacks and dividend yield) or become a target of the plethora of Private Equity firms with access to almost unlimited cheap and nearly free money.

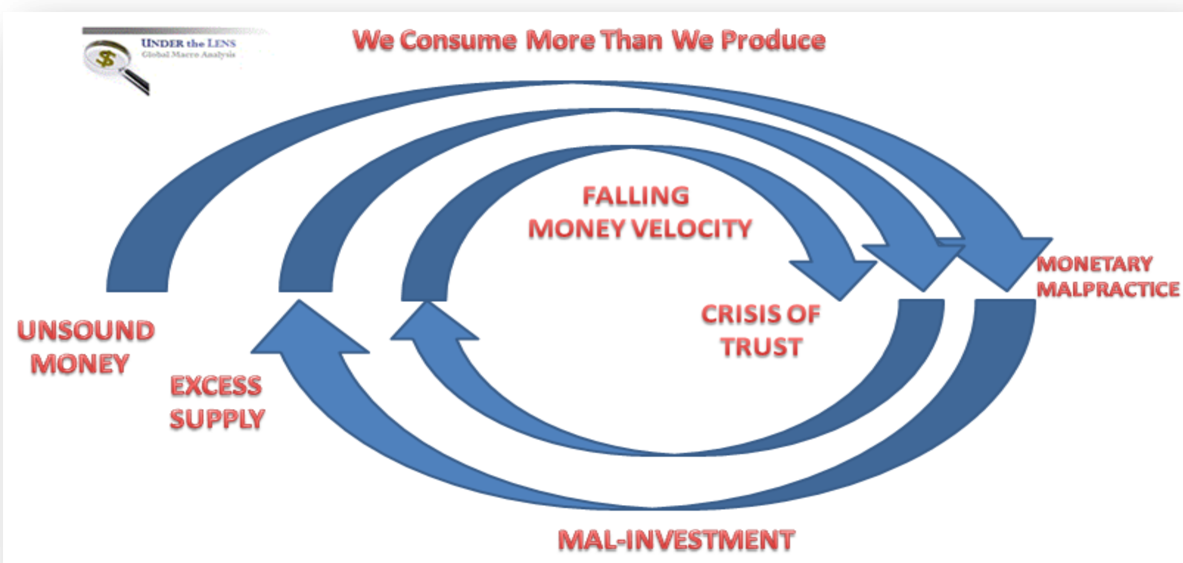
Few invest, banks don't lend and decent paying jobs become more and more scarce as competition grows for fewer and fewer good jobs.

FALLING MONEY VELOCITY

Less money moving through the economy stalls everything. Low and falling Money velocity which we have witnessed for a number of years now becomes something everyone wonders why it can't be fixed.

If only the banks would lend. If only the corporations would expand. If only more small businesses would start up. There is a reason for this!

Inevitable government regulations and programs to keep the system from fracturing only add to the reasons why investment slows further.



What we soon have without fully understanding it is a Crisis of Trust. People stop trusting in politicians, businesses, government programs & statistics etc.

Risk taking disappears.

CRISIS OF TRUST

To keep this crumbling structure of unsound money and consuming more than you produce, the government must resort to more advanced and aggressive policies of Financial Repression.

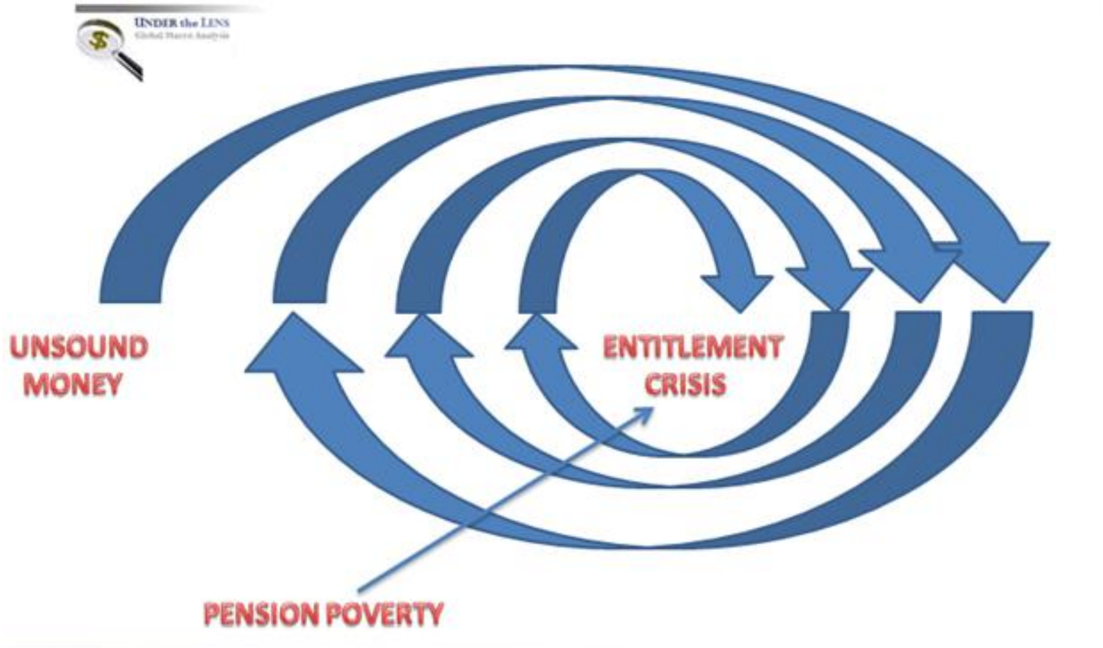
They must coordinate these policies with other central banks if these conditions go on too long as more and more countries are afflicted and succumb to the same debt induced programs, competitive currency devaluations and destabilizing market manipulation.

ENTITLEMENT CRISIS.

Effectively in many ways what we have here is a giant Ponzi scheme. Like luckless Bernie Madoff it all comes crashing down when more people want their money back than new money coming in. In Bernie Madoff's case it was a falling market and redemptions that caused this. As we see in Greece, Puerto Rico, Chicago etc it is becoming more and more about entitlement programs as the baby boomers reach the stage of taking out more than is going in.

Decades of promises to teachers, policeman, firefighters, and public servants are now coming due and the money is simply not there. More games are being played to keep the system afloat but Supreme courts are telling governments like the City of Chicago what it is doing is against the law.

With somewhere between $6T and $10T of underfunded pensions in America alone, the debt encumbered developed economies, with their large social entitlements, are coming unglued.



PENSION POVERTY

ENTITLEMENT CRISIS

- Greece
- Puerto Rico
- Chicago / Illinois

PENSION POVERTY

- Means Testing
- Inflation
- Social Security Tax – The 55% and 85% Surprise

The entitlement crisis in the US is about Social Security, Medicare, Medicaid, Food Stamps, the Disability Scam etc. The list goes on. According to Boston University Professor Laurence Kotlikoff, the real fiscal gap in America is $210T. He has had 500 economists sign off on his numbers along with 15 Nobel Laureates before presenting his findings and recommendations to congress. My interview with him is archived on the GordonTLong YouTube Channel.

What people fail to understand is that in America if you retire and have an adjusted Gross Income of over 34K you pay a 55% tax on your Social Security payments.

If you make over 44K you pay 85%.

Since people can't live on their Social Security checks today and the poverty level is 30K. If they get above the poverty level they effectively give their social security check back to the government in the form of income tax.

This will lock in Pension Poverty in the not too distant future for many America's especially since defined benefits pensions are gone and contributory benefits reflecting 401K's average about $18,400. About a half year of retirement expenses!

IF inflation arrives, which government policy is publically stating as its desired outcome of current monetary policies, these numbers will become even starker!

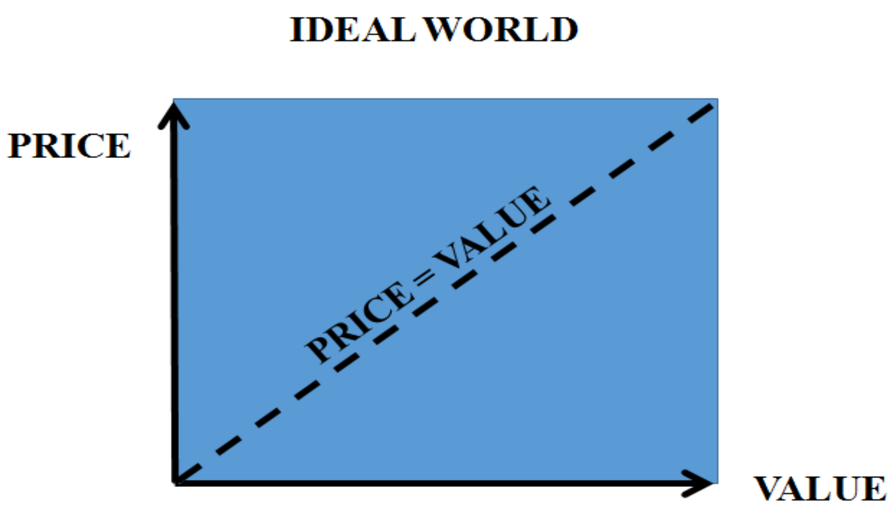
There is much more to discuss in our Monetary Vortex but I want time to consider what it is all doing to price and value as we distort markets, currencies and the cost of risk.

Let's consider what I will call the Value Vortex element of this Monetary Vortex.

VALUE VORTEX

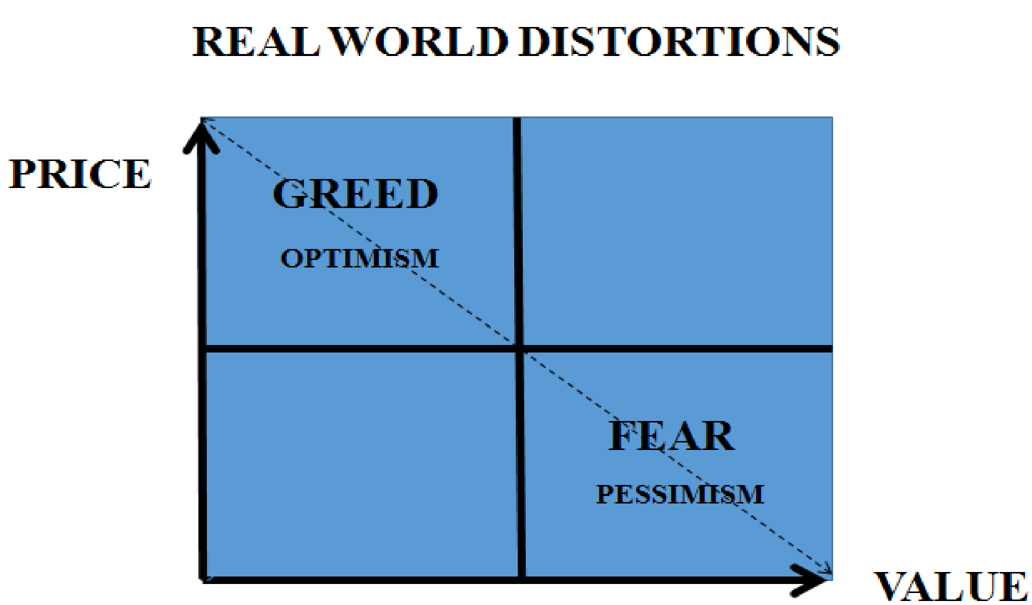
IDEAL WORLD

In an ideal world what we pay for something should match its value. The more we pay the more value we should get. No matter how we define value.



DISTORTIONS

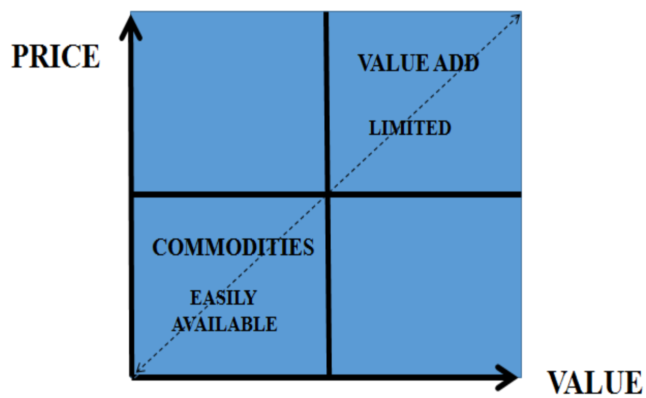
We are all well aware that markets don't operate that way and there is always a distortion from either over optimistic and greed driven markets or pessimistic and fearful markets often after major drawdowns.



VALUE ADD

Something we witness is that price sensitive commodities often have lower value and price because of their ready availability from multiple suppliers. Value add products and services are higher price and value because they are scarcer and often more difficult to get.

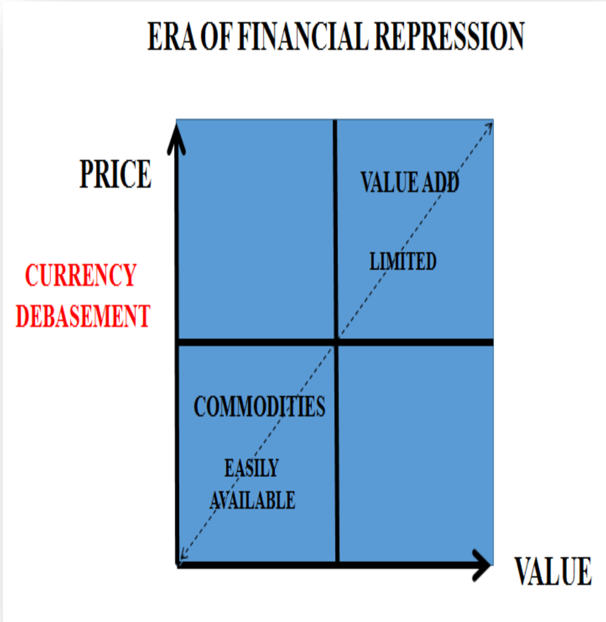
VALUE REALITIES



CURRENCY DEBASEMENT

What has occurred in our Monetary Vortex is currency wars and expansion off the money supply has intentionally debased the value of many currencies. Prices have gone up as the currency it is denominated has fallen relative to other currencies.

What this has done is to distort the Price axis on our diagram.

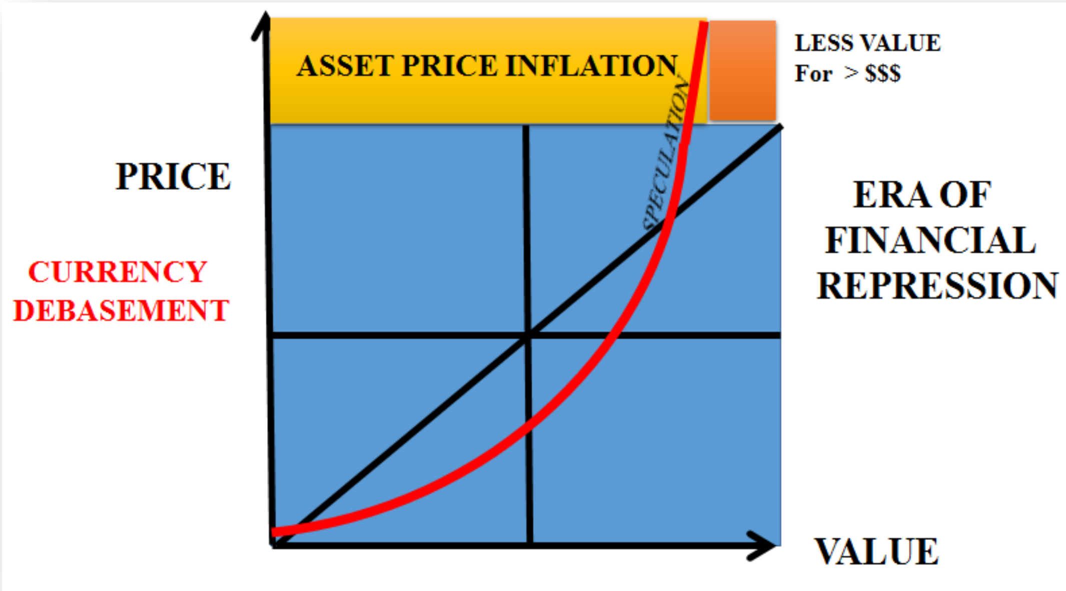


ASSET PRICE INFLATION

Specifically we have had unprecedented Asset Price Inflation.

This has shifted our idealized linear Price-Value relationship into something more geometric. Now we get less value for new price levels

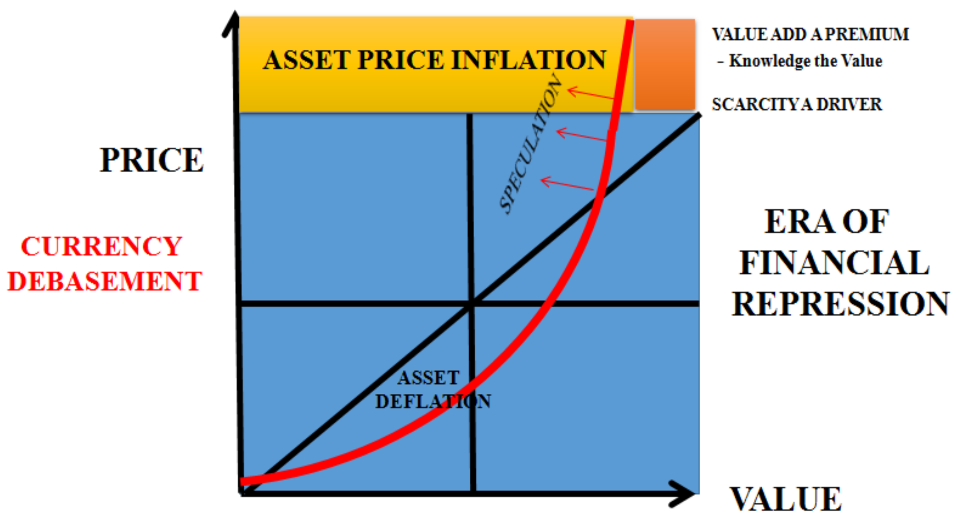
Additionally, higher value-add becomes quite significantly higher as it is sought out by more and more money.



VALUE ADD PREMIUM

In effect there becomes a premium to be paid for value add. Value-add becomes more and more about scarcity. Scarcity becomes a more important driver than ever before.

Scarcity in turn becomes more and more about Knowledge and Innovation than just physical materials.

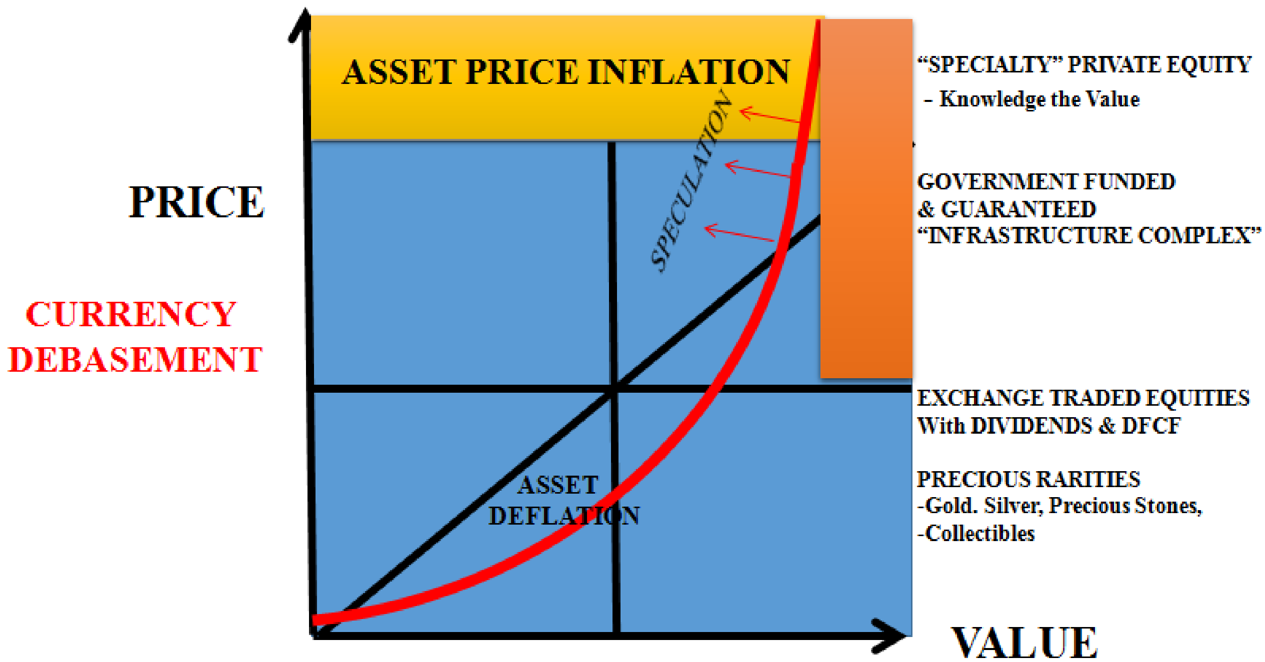


INVESTMENTS ARE CHANGING.

Today investments that solve these new developments are not on publically traded exchanges.

The risk adjusted basis of investment favors more and more government contracts where they have the ability to make guarantees no other counter party can make. Others can't change the law when things don't go as planned or make guarantees with tax payer money not yet received nor have an army to back up their claims and laws.

The whole vertical axis shown here on the right is changing.



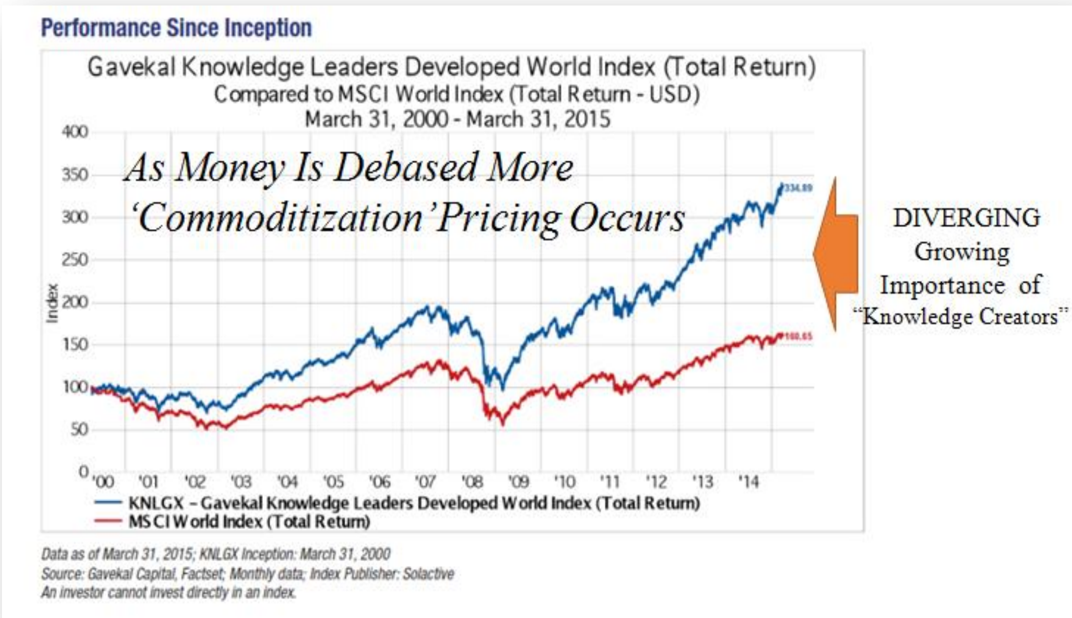
INNOVATION & KNOWLEDGE

As I mentioned Innovation and Knowledge are becoming top investment performers.

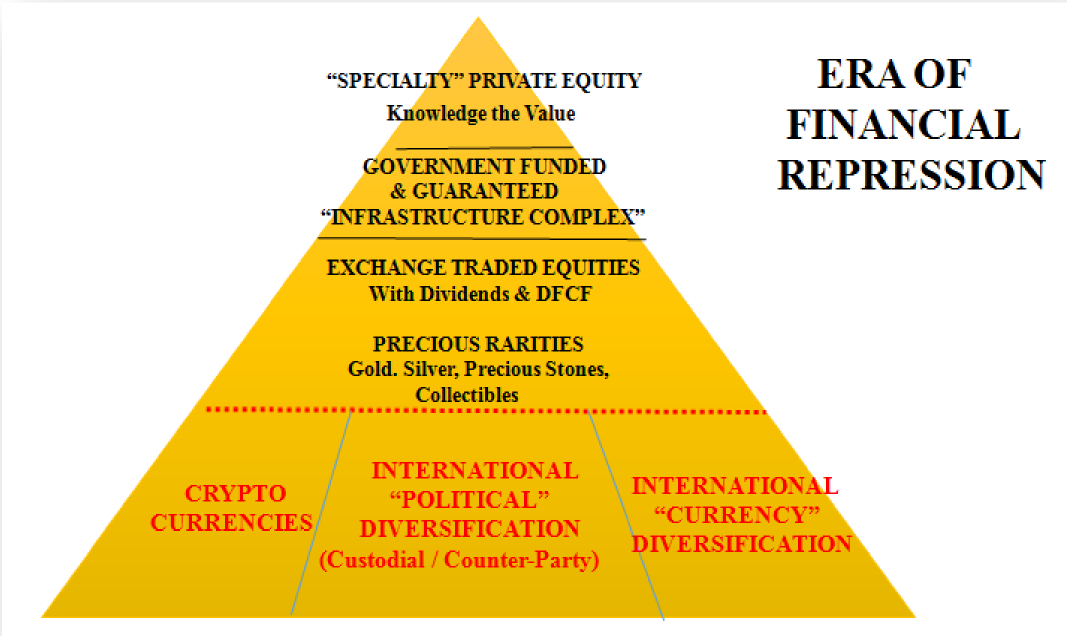
It really comes down to too much cheap money creating too much supply and commoditizing more and more product and services.

The gap is accelerating and can be expected to continue in this fashion as governments become addicted to increasing money supply to "stimulate" economies.

Of course, eventually this all will end. Quite abruptly!

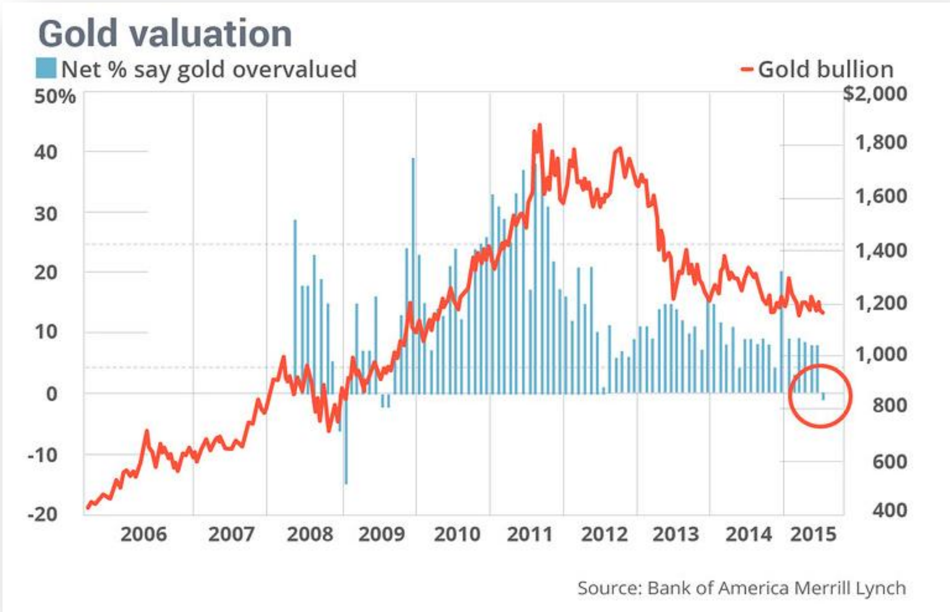


Until it does, the importance of the Value Vortex and the pyramid of value it creates becomes increasingly more important.



More and more institutions understand the importance of this; the difference between price and value, how money is no longer a store of value and how investment thinking must be altered.

The recent BOAML survey of large institutions was very telling when it showed that institutions for the first time since the financial crisis are beginning to value a barbaric store of value like gold!

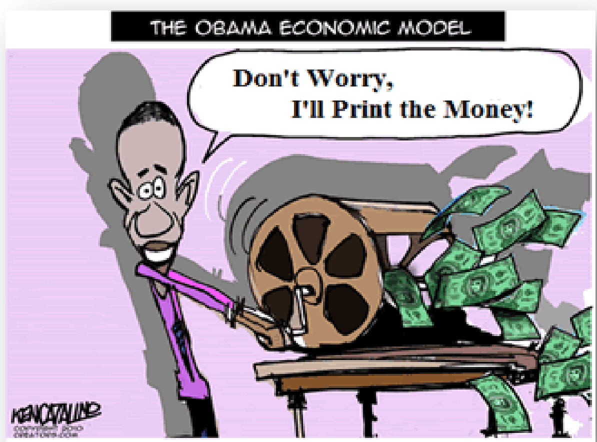


WHAT TO EXPECT

PRINT THE MONEY

In summary let me remind you – don't worry because you know what the government will do.

"Never forget throughout this turmoil: "They will print the money!"



Until it is useless and no one will want it!

Gordon T Long

Publisher & Editor
general@GordonTLong.com

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