THOUGHTS FROM THE FRONTLINE

Financialized Everything

By John Mauldin | February 12, 2022

Awash in Capital
Hair-Trigger Money
Import Trap
The Fed Piles On
Help Wanted
Flooding the Zone in Puerto Rico

Interest rates—the "price of money"—have been unusually low for most of this century, particularly since the 2008 crisis but going back to Greenspan's era. The wisest people I know differ on exactly why. Was it purely a policy choice, or the result of larger, less-controllable economic forces? I believe the answer is some of both. Whatever the cause, persistently cheap money has had consequences we are only beginning to recognize.

Ronald Reagan famously said, "If you want more of something, subsidize it. If you want less, tax it." He was talking about public policy but the point is broader. Economists of all stripes agree people and businesses respond to incentives. In economic theory, we are "utility-maximizing" rational creatures who grab whatever we believe will give us the most benefit for the least effort.

Behavioral economics says it's not quite that simple. However, there's no doubt that near-zero, zero, and below-zero interest rates changed the incentive calculations and decisions from what they were a mere 30 years ago. You can't look at policies or almost anything else prior to the early 2000s as a standard for today. The incentives of low interest rates have literally screwed (that's a technical economic term) things up.

Today I want to explore some of these changes. Often they make perfect sense in the moment, but over time and across the economy the negative effects add up.

Awash in Capital

A few months ago in Human Capital Losses I talked about the four factors of production: land, labor, capital, and entrepreneurship. Each has a price, which like anything else varies based on supply and demand. Interest rates are the price of capital, so they are higher when capital is scarce.

That's obviously not the case now. More the opposite: Capital is cheap because the world is awash in it. This is historically extraordinarily unusual. Modern banking and capital markets arose *because* capital was so scarce. We needed mechanisms to allocate it efficiently.

(Incidentally, the single best book I found describing the rise of corporations, banking, and all the skullduggery of the creation of Wall Street in the late 1800s is The First Tycoon, the incredibly well-told story of Cornelius Vanderbilt, who upon his death in 2022 dollars may have been worth $1 trillion. But then he didn't have an iPad and for most of his life didn't even have a modern flush toilet.)

Until recently, a big barrier to launching any kind of business was simply finding the necessary capital on affordable terms. This frustrated many entrepreneurs (including me at times in my early career) but served a purpose. Scarce capital tended to flow toward ideas with the highest odds of producing something consumers would buy. It was a sometimes-brutal process, but it led to more growth and higher living standards for everyone.

(Sidebar: In the late 1970s I began my career after graduating from seminary as a printing broker, having grown up in my dad's printshop from my early youth. I borrowed money at 18% to buy physical train carloads of paper to be able to service my customers. Long story, but I got free storage from printers that I worked with. They used my inventory like it was theirs, replenished it when they could. I got the ability to move to the front of the line, and it was all done on a handshake. You gotta love Texas! The specific paper we needed was (wait for it) suffering supply chain problems and the price was rising well more than 25% per year. I don't want to burst anybody's fragile expectation bubbles, but supply chain problems are one of the hallmarks of inflationary periods. We're going to have to solve the inflation issue to be able to fully solve the supply chain issues. Sigh. Back to the main plot line.)

Today, more capital is available than opportunities to invest it. This isn't new but has grown steadily more obvious. In the 1990s tech boom we began seeing Silicon Valley venture capitalists in the odd position of having to convince dot-com companies to take their money. Now it's reached the extreme of "Special Purpose Acquisition Companies," some of which are literally piles of money looking for some kind of profit opportunity. (SPACs can serve a useful purpose, and be very profitable for the right investors. No surprise, management is the key.)

There are more insidious effects, too. As Reagan said, if you want more of something just subsidize it. If capital is free, or almost free, businesses have the incentive to borrow large amounts. Why spend your own cash when lenders will throw more at you and charge practically nothing?

When everyone is playing with someone else's money, the connection between ownership and management frays and eventually breaks. Businesses are tempted to have less equity and more debt. Incentives aren't aligned as closely as they should be. Companies do nonproductive and even counterproductive things. Stock buy-backs at peak prices?

Meanwhile, return-seeking investors go through contortions trying to find some kind of edge. This, combined with technology, led to the recent "financialization" of almost everything.

Hair-Trigger Money

Below is something I wrote last spring amid the Robinhood/GameStop/meme stock craze (see Tsunami Warning). I was talking about how "odd lot" trading was no longer odd.

> "By the 1990s, back office technology had made the whole round lot preference obsolete. Brokers stopped caring how many shares you traded. In effect, a "round lot" became one share. But now it is even less. Robinhood and many other trading platforms let users trade *fractional* shares, as little as 1/1,000,000 of a share. I believe this may be more consequential than is generally recognized.
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> "Look at the share prices for of some of today's top companies: Apple (AAPL) is around $130. In the old round-lot world, you would have needed $13,000 to trade it efficiently. Now you need less than a penny. This vastly expands the universe of people who can trade Apple shares. And Apple is low-priced compared to some other popular names like Tesla (TSLA) around $750, or Amazon (AMZN), which is over $3,000 per share.
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> **"We have, without really noticing, severed the connection between share price and liquidity. This matters in ways I think we may not fully understand.** Combine it with game-like mobile apps that let people buy and sell in individually tiny amounts that add up to the big numbers once reserved for giant institutions. And without any kind of institutional decision-making process to constrain rash moves.
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> "Further add trillions in government cash payments, often to people with time on their hands because they are unemployed, and who need ways to generate income. Of course, some turn to stock trading. It's an attractive 'side hustle' for a time when Uber driving is less attractive. If all you have is $100, that's okay.
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> "We have raised a generation playing adrenaline-charged video games. For a relatively small stimulus check, they get to play in a game where Dave Portnoy assures them that stocks only go up, or they can 'stick it to the man' in GameStop. Sigh…
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> "In the bigger picture, all those small accounts add up to enormous sums of hair-trigger money. Some of it has much higher risk tolerance. Users don't see it as a nest egg to preserve. In their minds, it's more like buying gas to get to work—something you have to burn. The whole concept of a stock being overvalued or undervalued doesn't apply. They just want it to move.
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> "Where all this leads is uncertain but I suspect it won't be good."

You can't ask for a better example of "financialization" when trading stocks is as normal as buying groceries. Capital is now so cheap and abundant it has become a plaything of the masses.

This attitude affects the corporations whose stocks are the toys. If shareholders don't care whether the business works, the whole "maximizing shareholder value" concept loses its meaning. Sadly, too many executives can stop worrying about long-term growth and efficiency and simply milk their assets for short-term gain.

One way they do that is to borrow some of that cheap capital and simply buy competitors, or those they think might become competitors in the future. This lets them raise prices and expand profit margins. The higher prices contribute to inflation and the higher margins help raise stock prices—both of which, not coincidentally, are happening right now.

This was once more difficult because the government tried to prevent "anticompetitive" business combinations. The 1890 Sherman Antitrust Act gave it that power and Washington wielded it aggressively (sometimes too much so) for many decades. It broke up large monopolies like railroads, oil companies, the Bell System, etc. More recently it forced Microsoft to open its operating system to alternative web browsers.

Looking back, I think the Microsoft case had deeper effects than realized at the time. A deep-pocketed industry began seeing government as a barrier, and started investing some of its abundant capital in political influence. It worked, too. Washington adopted a more laissez-faire attitude, allowing today's tech giants to carve out highly profitable niches in which they face little competition. This spilled over to other industries. The result was what I called [Capitalism without Competition] in a 2019 letter. Quoting my friend (and co-author of two books) Jonathan Tepper's then-new book:

> "'Free to Choose' sounds great. Yet Americans are not free to choose.
>
> "In industry after industry, they can only purchase from local monopolies or oligopolies that can tacitly collude. The US now has many industries with only three or four competitors controlling entire markets. Since the early 1980s, market concentration has increased severely. We've already described the airline industry. Here are other examples:
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> - Two corporations control 90 percent of the beer Americans drink.
> - Five banks control about half of the nation's banking assets.
> - Many states have health insurance markets where the top two insurers have an 80 percent to 90 percent market share. For example, in Alabama one company, Blue Cross Blue Shield, has an 84 percent market share and in Hawaii it has 65 percent market share.
> - When it comes to high-speed internet access, almost all markets are local monopolies; over 75 percent of households have no choice with only one provider.

- Four players control the entire US beef market and have carved up the country.
- After two mergers this year, three companies will control 70 percent of the world's pesticide market and 80 percent of the US corn-seed market."

It gets worse. My friend and extraordinarily successful venture capitalist Joe Lonsdale wrote a *Wall Street Journal* op-ed this last week. Joe is as pro-capitalist as one can possibly get, but he points out that Amazon's cloud service business plus its advertising business is extraordinarily profitable and lets their online product sales operate a multibillion dollar loss. No new competitors can afford to complete with someone willing to lose billions of dollars to maintain market share.

It's not "healthy competition" when a handful of large firms control the vast majority of commerce. It's actually unhealthy because innovation typically comes from small businesses. But low rates favor the large and the large are squeezing all they can from this advantage. The pandemic effects made it even worse.

These are problems we might be able to solve, or at least minimize. But there's a bigger and more difficult one, too.

Import Trap

Around the year 2000, give or take a few years, we had three important developments.

- Internet and information technology matured and became less expensive. (That Microsoft monopoly case was decided in 2001.)
- The Federal Reserve became enamored with ultra-low rates.
- China joined the World Trade Organization and globalization accelerated.

All these were disinflationary, at least initially. Technology reduced costs for many businesses, letting them lower prices. Cheap financing had a similar effect. And of course globalization brought us shiploads of inexpensive goods. But this last one had a particular effect on the US, one often overlooked.

The post-World War II monetary regime made the US dollar the "global reserve currency." This has been called the "exorbitant privilege" allowing the US to both borrow and lend in its own currency. But in some ways, it's also an exorbitant *burden*.

Let's follow the bouncing ball for a minute. When Americans buy imported Chinese goods (or Saudi oil or…), we pay for them with US dollars. It's a voluntary exchange that satisfies everyone. Americans wanted the goods more than they wanted the dollars. Chinese or other exporters want to sell goods and buy dollars. Everyone's happy.

What happens to these dollars we send overseas? Because ours is the reserve currency, they eventually find their way back to the US. Foreigners use their dollars to buy American assets, often US financial assets. Our Treasury securities are popular because they are easy to buy and quite liquid.

This arrangement is one reason capital is so abundant in the US. We (the US economy collectively) can buy imported goods without exporting our capital stock. That is not the case everywhere, and is a top reason our interest rates are so low. Decades of globalization-driven giant trade deficits have had a cumulative effect. Greenspan noted this several times in his career, and Bernanke echoed it. It clearly keeps US interest rates down.

Here's the problem: The only way this can change is if US consumers spend less on imported goods. That's not impossible. The pandemic certainly exposed the problems of depending on other countries for key components and materials. Businesses are bringing supply chains home, but it's a slow process. This last quarter, the trade deficit was extraordinarily high. But we can't reverse 30 years of trade deficits in a few years. This will take decades, if it happens at all. Don't hold your breath.

The reality is that as long as the US runs a giant trade deficit, we are going to have lower interest rates than we would otherwise. That's not anyone's choice. It is just math, and it won't change unless we either greatly reduce imports, or modify the US dollar's status.

The Fed Piles On

"Piling on" is a serious penalty in American football, and rightly so. Players can and do get hurt in dogpiles. Similarly, in an economy with other forces already pushing interest rates down, the Federal Reserve "piles on" to push them even lower.

As I described last week, John Maynard Keynes quoted Walter Bagehot's line: "John Bull can stand many things, but he can't stand 2%." At the time, British consuls (a kind of perpetual bond) were paying 4%. The British central bank rarely let rates go as low as 2%. Bagehot and later Keynes agreed low rates discourage savings. They encourage investors, and sadly many retirees, to "reach for yield" in riskier investments at the absolute wrong time.

Low interest rates have winners and losers. They favor large businesses and wealthy investors but punish the bottom 70–80% of the economy. That's why I say the Federal Reserve has made the income and wealth disparity gap worse.

Yes, globalization and the trade deficit would keep short-term US rates low, but not 0.08%. The Fed is supposedly fighting inflation, but will still buy $30 billion worth of Treasuries and mortgage bonds this month. Inflation came in white hot Thursday, and it was artificially low because of the way they reflect housing costs. Properly calculated inflation would probably be 10%.

This is what happens when you let a committee think they can manage an extraordinarily complex and chaotic $20 trillion economy like some demigods. If the US economy can't handle 2% short-term interest rates, we are in deep kimchee.

As of Friday morning, the market is already pricing in a 0.5% rate hike in March. Some Fed governors are finding the stomach to call for quantitative tightening as well. The 2-year bond yield had its biggest one-day jump since 2009. Volatility anyone? This is precisely what happens every @#$%#$%# time the Fed screws up. To think the market and the economy can shrug this off, on top of the other issues we face, is whistling past the graveyard.

Long-term, I am the ultimate optimist about the US economy. We are just that damn good. But in the short term, we are hobbled by a Federal Reserve that has made too many mistakes and now has to play catch-up. Like a Super Bowl team down 21 points in the last quarter (think Super Bowl XXIX, San Francisco versus San Diego), they start taking faster and riskier gambles. As both a fiduciary and as a participant in the markets, dear gods I hope they can figure this out.

Damon Runyon once remarked, “The race isn’t always to the swiftest or the fight to the strongest, but that’s the way to bet.”

Like Larry Summers and other mainstream economists, I sincerely wish the Federal Reserve can engineer a major fourth-quarter comeback. I hope Jerome Powell proves to be the Tom Brady of Fed chairs.

But as I have been saying for some time, I have already hedged that bet. I recommend you consider the same.

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Flooding the Zone in Puerto Rico

Normally, February in Puerto Rico is very dry. Not this year. Locally we got 10.6 inches of rain in two days (mostly one day) which is 2 inches more than fell during Hurricane Maria. Fortunately, the ground was dry, so no major flooding.

I could really write a whole letter on the news from just the last few days. There is so much happening. The data inside the CPI numbers is really fascinating, and the consumer confidence numbers are mind-boggling. I simply have no way to process this information. Seriously, reporting from the survey: “The entire February decline was among households with incomes of $100,000 or more; their Sentiment Index fell by 16.1% from last month, and 27.5% from last year. Noteworthy, the entire decline also occurred among Democrats and Independents, with Republicans reporting a slight gain in early February, although still having the lowest level.”

Maybe upon reflection I will comprehend what that means, if it means anything at all. In the meantime, I will enjoy Puerto Rico, figure out where Shane and I will watch the Super Bowl (guilty pleasure: watching the ads) with friends. Embarrassing admission: I had to check to see who is playing.

It’s time to hit the send button. Have a great week.

Your curious what the Fed will do (as opposed to should) analyst,

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