



## QE: the blowback to come

backlash

ricochet

repercussions

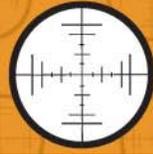
the boomerang effect

recoil

back fire

adverse consequences





*Sooner or later everyone sits down to a banquet of consequences.*

- Robert Louis Stevenson

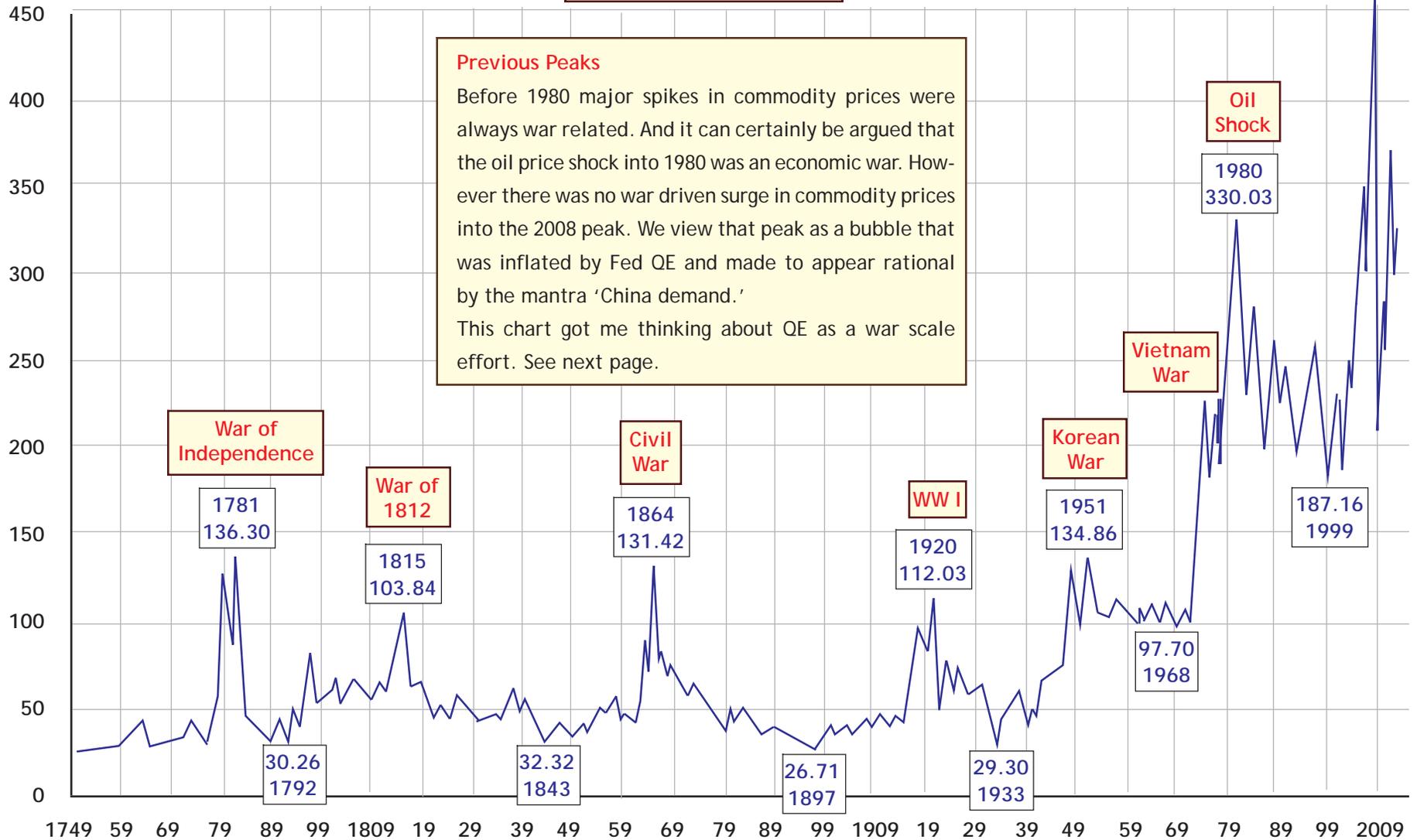
### Main Points

1. History is written as much by the unforeseen consequences of key events as by the events themselves. We prefer not to think in these terms, but history clearly reveals that the adverse consequences of well intended efforts often have a much more dramatic and lasting impact than the original efforts themselves.
2. In fact history suggests a law of adverse consequences where the more insistent and forceful the well intended effort, the more dramatic, powerful and harmful the blowback. In simple terms, attempts to force the world to improve have always ended badly.
3. This law of adverse consequences is a very common phenomena in medicine and is known by the euphemism of 'side effects'. Adverse drug reactions to prescribed medications are the fourth leading killer in America, right after heart disease, cancer, and stroke. However this expression of the law of unintended consequences gets even less press than its expressions in human history. Neither is a popular topic.
4. One could easily write several volumes of history focused exclusively on the unwelcome repercussions from otherwise well-intended efforts. However as this is a subject that we would all rather avoid I suspect it would be a very difficult book to market.
5. Instead of a book I have opted for two pages of examples. The present situation strongly suggests that the high risk of unexpected blowback from current economic policies are much more deserving of our full attention than the past history of unwelcome consequences.
6. QE has already created what is arguably the most bullish market sentiment in history. And that extreme bullish sentiment has already driven most stock indices to new all time highs. So now would be a good time for some sober reflections on what could go wrong.
7. One sector that seems dangerously poised to go badly wrong are the junk and emerging bond markets. What will happen when Treasuries start yielding the same rates as previously issued junk debt? A massive exodus will happen. Junk bonds and emerging market debt will become a disaster area.
8. We already know how wildly successful Fed stimulus has been at creating speculative bubbles. Fed inflated bubbles that have already burst include a Dot-Com bubble, a credit bubble, a real estate bubble, and a commodity market bubble. The biggest bubble of them all is still inflating. That would be this stock market bubble.
9. There are now fewer banks than ever before in modern history. And the biggest banks are larger than ever before in history. The war against 'too big to fail' was lost before it began. Fewer, bigger banks means a more fragile financial system.
10. The worst of the bullish sentiment extremes of previous major stock market peaks have all returned. Analysts are positively gushing with ebullience. There is a competition to see who can come up with the highest targets for the various stock indices. No one sees any downside risk. All are confident that the Fed can and will fix anything. This is a situation ripe for adverse consequences. This is a market where blowback will be synonymous with blind-sided. No one will prepare for what they cannot see coming.



The QE-China Bubble 2008 462.74

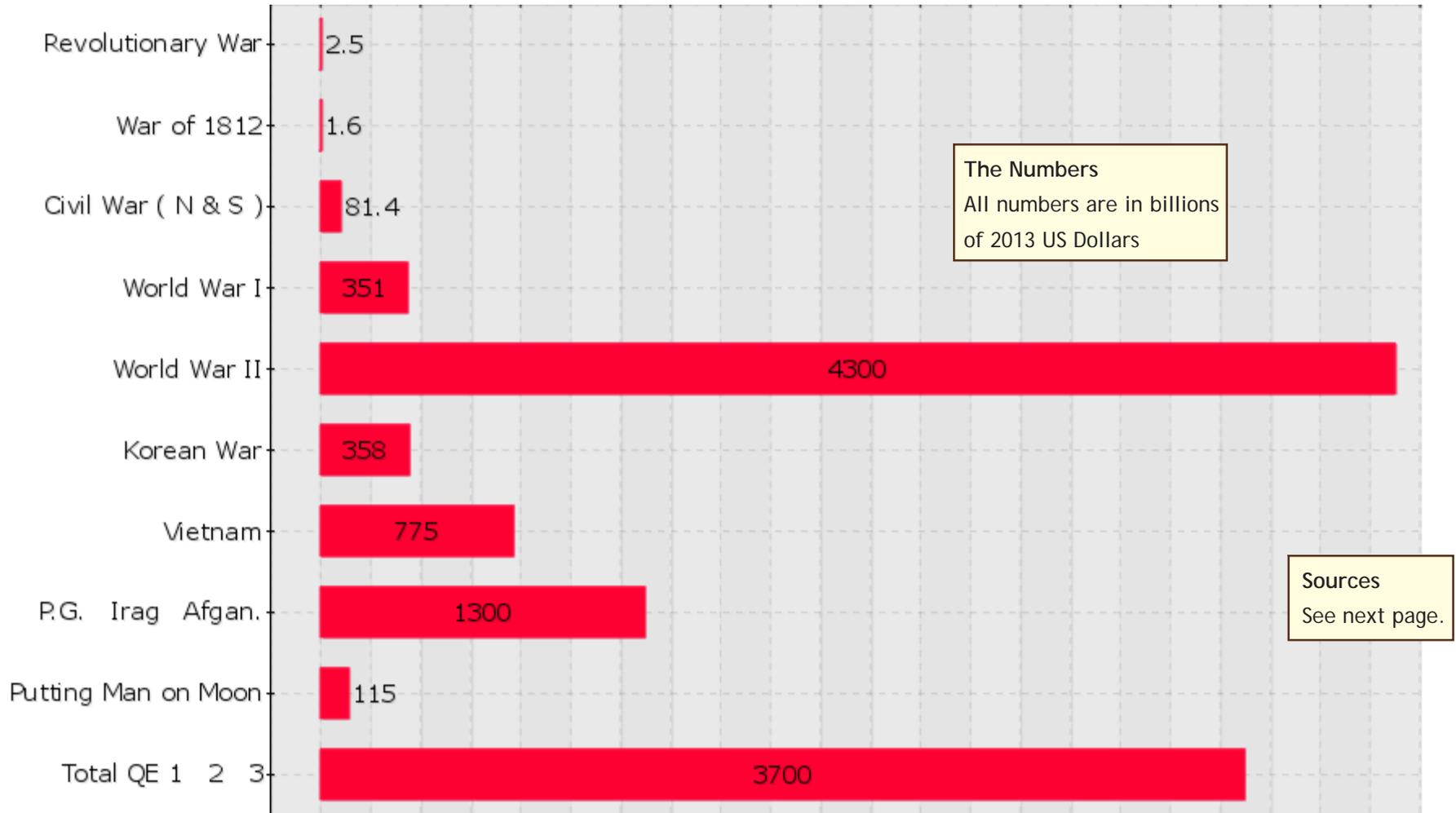
The CRB Index from 1749





### Comparing Costs: Major US Wars versus Quantitative Easing

The chart on the previous page suggests that the magnitude of the Federal Reserve economic stimulus program is only comparable to previous major war efforts. The dollar costs plotted here bears that out.





## Sources

### War Costs

All of the war costs on the previous page were taken from one report dated 29 June 2010. That report was prepared by Stephen Dagget at the Congressional Research Service. I adjusted his numbers to 2013 dollars. You can find his report in PDF format on-line. However some further comments may be useful here.

### Civil War

The Civil War number combines the Northern or Union costs and the Southern or Confederate costs. In 2011 dollars the price of waging the war for the Union was \$59.6 billion dollars and \$20.1 billion for the Confederacy. I simply added these two numbers and then converted to 2013 dollars.

### Post 9/11 Wars

Here I combined the costs of the Persian Gulf war, and Iraq war, and the war in Afghanistan into one category and then adjusted to 2013 dollars.

### Sending a Man to the Moon

I thought it would be interesting to compare the costs of sending a man to the moon to the costs of QE. Most references to the cost of putting a man on the Moon only cite the Apollo project. But of course that is very wrong. Apollo arose from Gemini which grew out of Mercury. So for the true cost of sending a man to the Moon I included all costs for the Mercury missions, the Gemini program, the Lunar probes, the Apollo capsules, the Saturn V rockets, and the Lunar Modules. I relied on numbers gathered from NASA by the Artemis Project. I then converted those costs to 2013 dollars.

## World War II versus Quantitative Easing

### WW II

World War II transformed the United States from a sleepy agricultural enterprise into the world's dominant economic super-power, and defeated both Nazi Germany and Imperial Japan at the same time. It may seem entirely callous to calculate US Dollar costs for a war that claimed 15,000,000 battle deaths, 25,000,000 battle wounded, and civilian deaths that exceeded 45,000,000 but there is a point to this exercise.

The second world war defeated the strategy of geographical conquest through militarism as a national policy. Of course WW II had it's own undesirable blowback as anything on this gigantic a scale would. However it seems pretty clear that replacing fascism and militarism with democracy was a step of progress for mankind.

### WW II and QE

Since the 1950's many have argued that it took World War II to pull the world out of the Great Depression. As a life-long student of the Great Depression Bernanke must be aware of this debate. In terms of the dollar amounts involved, World War Two is the only project comparable in size to QE. So it seems reasonable to assume that Bernanke's goal here is to have QE fulfill the economic role of a World War Three; a war-free method of pulling the world out of the Great Recession. However human history suggests that the sheer magnitude and forced nature of the QE program all but ensures serious, unexpected and adverse consequences.



| <u><i>Global examples of Well Intended Efforts...</i></u>  | <u><i>... and their Adverse Consequences</i></u>   |
|--|--|
| The French Revolution - to overthrow a corrupt and bloated royalty.  | Gave rise to the 'Reign of Terror' and the genesis of political extremism, then the rise of Napoleon, then the birth of total war and the ensuing utter devastation of Europe and Russia.  |
| The Treaty of Versailles - to end a horrific war of attrition.   | Plunged Germany into economic collapse, which gave rise to the Nazi party in Germany and militarism in Japan, and which thereby ensured a global war that promised to eclipse the horrors of World War One.  |
| Operation Barbarossa - Hitler's effort to free Russia from communism. ( The irony here was severe. A popular WW II joke in Germany was that the only difference between Berlin and Moscow was the temperature. ) | The Nazi effort united the Russian people behind Stalin as no amount of brutal purges could. The end result: over half of a formerly free Europe was locked behind the iron curtain of communism for several decades.  |
| The 1953 British MI6 and American CIA orchestrated overthrow of the democratically elected government of Prime Minister Mosaddeq in Iran. The goal was to reverse the nationalization of Iran's oil industry.    | Ensured the USA would ever after be rated the #1 enemy of Iran. This led directly to the 1979 Iranian revolution and the US hostage crisis. And it still fuels tremendous resentment in Iran. And it did absolutely nothing to stem the rising tide of oil industry nationalizations across the globe.                                   |
| Austerity programs In Europe designed and implemented to solve their big financial crisis.   | Created on-going depressions in Greece, Spain, and Portugal, and deep recessions everywhere else in southern Europe. Gave rebirth to right wing extremism and revealed a deep cultural divide between northern and southern Europe. The political and economic reverberations of this exposed cultural divide are still unfolding today. |



| <u><i>US examples of Well Intended Efforts...</i></u>   | <u><i>... and their Adverse Consequences</i></u>  |
|---|---|
| <p>The National Prohibition Act, 1920 to 1933, USA - to reduce alcohol related problems. It was thought that alcohol consumption was the root cause of most personal and social problems.</p>   | <p>This act quickly became the single biggest boon to organized crime in US history. And there was a corresponding huge increase in the corruption of public officials and law enforcement. And Prohibition actually reversed a previously existing downward trend in alcohol consumption. The usage of other more dangerous drugs also rose sharply.</p> |
| <p>Government efforts to spur consumption from 1921 included sharply reduced taxes on the wealthy, easy money, and an increasing reliance on debt financing. This led to the 'Roaring Twenties.' The roar in the twenties was the noise made by an inflating bubble of consumption.</p> | <p>Bubbles always burst. The bursting of the consumption bubble of the 1920's led directly to the Great Depression.</p>   |
| <p>The US 'War on Drugs' - from 1971</p>  | <p>This effort consolidated the profits of drug cartels, made Mexico into a war zone, and resulted in the US having the highest incarceration rate of any country on the planet. With 5% of the world's population the US now has over 25% of the world's prison population.</p>  |
| <p>In 'Operation Cyclone, the CIA spent over \$4 billion to train the Mujahideen to fight the Soviet occupation of Afganistan, 1979 to 1989.</p>  | <p>The Mujahideen became Al Qaeda.</p>  |
| <p>The NSA war on terror - to protect American freedoms and the American way of life.</p>   | <p>Recent revelations have made clear that the NSA has taken our freedom to privacy. A study cited by Bloomberg estimates that resulting losses in US technology business could reach 180 billion by 2016.</p>  |



### Learning from History

I am not bearish on the human race. When I read history I see things getting better. When I read history I find the slow replacement of brutality with compassion. When I read history I find the long term trend to be the replacement of centralized authority with local self-determination. And I find that every single effort to fight these long term trends has failed. And as history continues to unfold the efforts to fight these trends tends to fail more quickly, more dramatically, and more decisively.

There is an ancient Chinese proverb that states “Plan too far ahead and nature will seem to resist.” That aphorism definitely resonates with my experience and observations. If there is something inherent in the flow of time that unfolds an improvement in the human condition, then there is also something in the nature of things that resists the application of force, whether well intended or not.

If all of the above is an accurate accounting of things, then the key issue for policy makers is finding the fine line that separates supporting the natural flow of human evolution from attempting to force change. The former will help while the later will end badly. The question today has to do with Quantitative Easing. Is QE a gentle nurturing of economic evolution or is it the next doomed attempt to force things to get better? The QE program is so enormous, and relentless, and insistent, that I fear it is the later. And if QE is a huge attempt to force the economy to improve, than we had better start bracing for the blowback.

### QE: the blowback to come

What kind of blowback should we prepare for? The lesson of history is that trying to force things to get better does not merely create unwelcome repercussions. It does not merely slow the pace of natural evolution. Attempts to enforce a certain outcome always appears to create the opposite effect. We do not find a law of adverse consequences. We find a law of opposite impacts.

Let us review the sample examples from the previous two pages. Every effort to jam an ideology or a plan down the throat of the world only creates the opposite of the intended effect. I would maintain that this is one of the few lessons from history that can be relied on.

If the Federal Reserve is trying to force feed us prosperity then the inevitable blowback will be adversity. If the Fed is trying to compel the most dramatic economic recovery in history, then the blowback may well be the deepest depression in history. If the Fed is trying to enforce confidence and optimism then the blowback will be fear and despair. If the Fed is trying to force consumers to spend then the blowback will be a collapse in consumer confidence.

I sincerely hope that I am completely wrong here, that I am missing something, that there is a flaw in my logic. However until I can locate such a flaw I must trust the technical case for treating this Fed force-fed rally in the stock market as something that will end badly. See next 3 pages.