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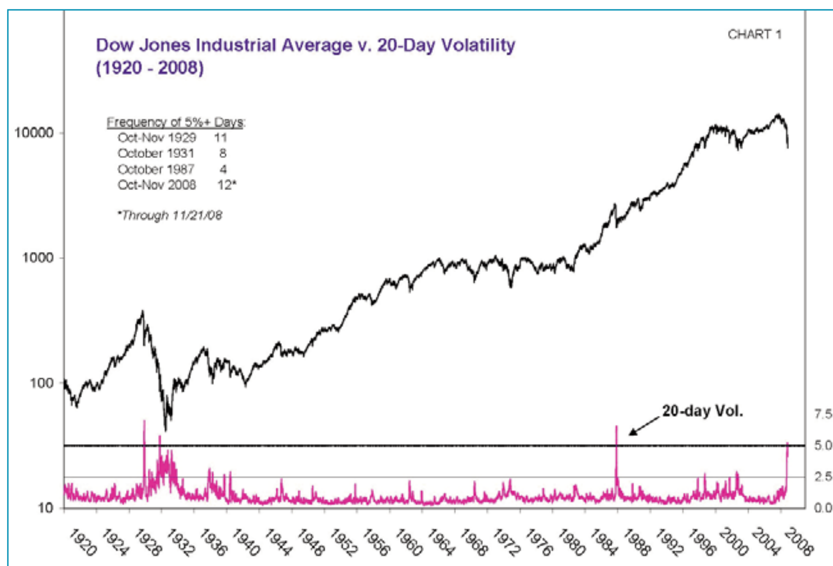
listeningin

Unconventional Clues

Contrary Troika Looks At History Searching For A Way Forward

There's nothing ordinary or conventional about the trio of ***Dean LeBaron, Walter Deemer and Mark Ungewitter****; nothing to explain how the three highly disparate professionals might have happened to join forces to try to thrash out a way out of this enveloping economic miasma. Nothing that is, except abiding intellectual curiosity and a certain shared spirit of innate rebellion against convention. That's how Dean, the founder and former chairman of Batterymarch Financial Management, inventor of index funds and pioneer of quantitative investing came to together with Walt, the legendary technical analyst who has published "Market Strategies and Insights" since 1980, capping a long career marked by stints with the likes of Bob Farrell, Gerri Tsai and Putnam Management. And also with Mark, a low-key and buttoned-down VP and portfolio manager at Charter Trust Co. — a plain-spoken New Hampshire-type who specializes in "private wealth management" and yet cheerfully admits he makes his dough by reading charts. The venue was last fall's Contrary Opinion Forum in Vermont, held just as both the foliage and the latest installment of the financial crisis were peaking. The troika was stunned by the lack of awareness they encountered all around and*



resolved to write something; to shake things up a bit in smug analytical circles, and to goad discourse forward on the urgent topic of how to get out of this mess. Their paper, like its authors, has proven a mite, well, too unconventional, for its intended platform, an academic journal. When a copy found its way to my desk, however, it did exactly what they hoped — provoked and intrigued. A conference call followed late last week. Share the stimulation.
KMW

How did the three of you happen to get together to write a paper on "The Way Forward"?

Dean: We were at the *Contrary Opinion Forum* in Vermont in the middle of last October, as the markets were falling apart, and were struck that nearly everyone there was bullish. So the three of us got together and decided, hey, we had bet-

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ter think this through.

Walter: Somebody made a presentation one day saying that the S&P might bottom around 965 and, if not there, at 940. Then somebody else raised his hand, interrupting him, and said, "It just closed at 910." It was the next day that the Dow opened down 700 points as we sat there.

Dean: Mark was at the conference at my instigation and one of the hooks I had used to get him there was the chance to meet Walt, so the three of us were chumming around a bit–

And naturally, after a few libations, you decided to write up a solution to what's ailing the markets?
Dean: There *were* cocktails involved at the forum – but not in the writing. I'm only the lead author, as I say, by virtue of the fact that I'm senior in age. Other than that, the effort was at least equal; we bounced everything back and forth.

You can't really be surprised that the *Financial Analyst's Journal* passed on the opportunity to publish your paper, can you? Not when it's utterly devoid of algebraic equations.
Dean: No. I'm very sympathetic to them; I'm on their so-called advisory committee and I can see their point. Our paper is different from their normal stuff – but that's why we did it, of course. This isn't the time for conventional thinking. Besides, Walter and I have done some mischievous things in the past, so we thought it would be fun to collaborate again.

You have? Like what?
Dean: Going way back to when Walt was working at **Putnam Fund**, we would meet from time to time under a foggy lamppost –

Wasn't that high treason? Consorting with a rival?
Dean: No, it wasn't that. It was just that I was on the so-called fundamental side of things and he was on the technical side, so in both cases we had to hide our collaborations from our respective communities.

Walter: But what we found was that we were really talking about behavior, so we *could* talk to each other. Which is why I think **Bob Farrell**'s recent quote is so good, "History does not repeat itself exactly, but behavior does."

Dean: It is exactly on target, which is exactly what you'd expect, considering the source. In any event, Walt and Mark and I didn't get together to write that paper just to make an academic statement for the sake of making an academic statement. That doesn't do it for us. We are practical guys. We want to know how something is going to affect investment management or what does it mean for government policy.

"What Dean is being too much of a statesman to say is that we really wrote the paper because there are roughly 100,000 subscribers to the *Financial Analysts Journal* and 99,750 of them – at least – were blindsided by all of this."

Then why doesn't the draft of your paper that I've read go into those practicalities?
Just because we thought that, for the purposes of periodicals like the *FAJ*, those practicalities really wouldn't matter. By the time it came out, there would probably be a whole new set of circumstances.

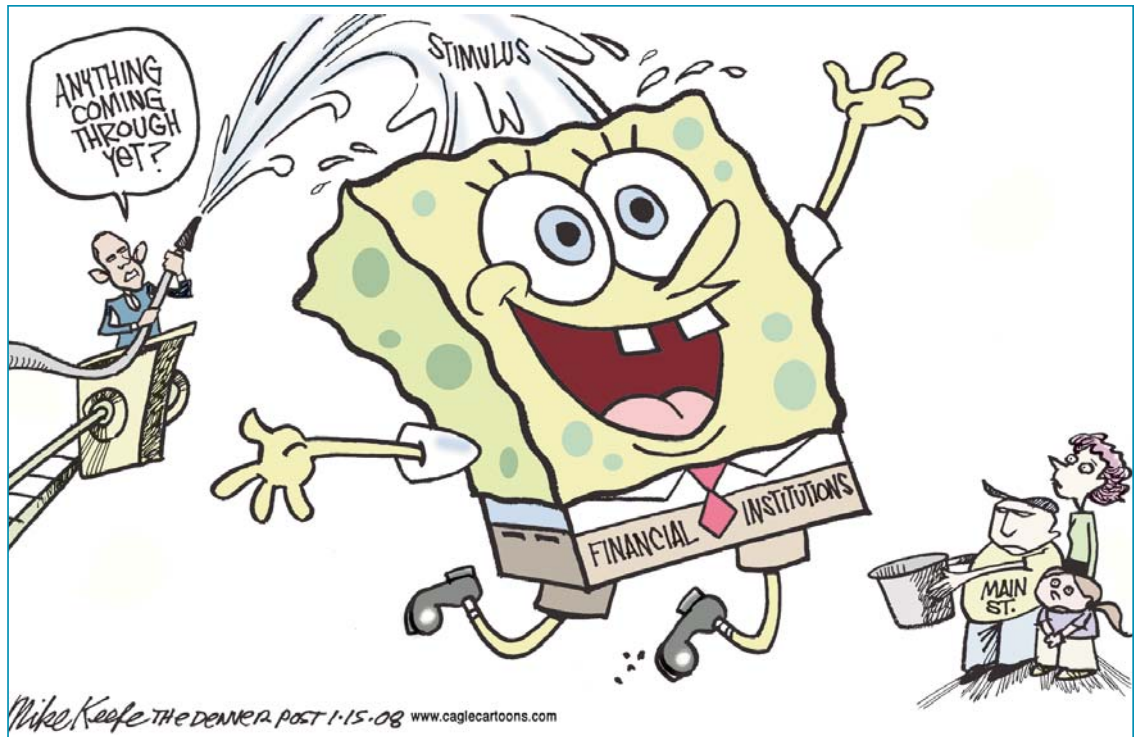
Walter: What Dean is being too much of a statesman to say is that we really wrote the paper because there are roughly 100,000 subscribers to the *Financial Analysts Journal* and 99,750 of them – at least – were blindsided by all of this. What we are saying is that they had better figure out why they missed it. Maybe they should even look at things they've been ignoring.

Dean: I think that's fair. I mean, most big things are not big unless most of us miss them as they are developing. As Walt has told me many times, the most dangerous things to say in the investment business is that "It's different

this time."

Walter: Right.

Dean: Something truly different only happens maybe once every 50 years or so. But when it does happen – when you get a hurricane in New Orleans – it *really* happens. And then it is, indeed, *different*. This just may be one of those times. I guess the point to make here, which we may not have hit as hard as we should have in the paper, is that a number of the things that we might do proscriptively as government policy may be harmful to other things that may be going on.



How so?

Dean: Well, one of the things we hint at is that we could have deflation and inflation at the same time. So if you fight deflation, which appears to be what we're doing from a Keynesian standpoint, you may actually be making things worse in terms of aggravating inflation later. When I first went to Russia years ago, the Russians explained to me how they play chess. They play multi-dimensional chess, as if four games are going on at once on the board in a single game. From their standpoint, Americans play checkers; they do one thing at a time in a series. This may be one of those occasions where you have to play multiple games at the same time–and hope not to run into too many conflicts from one level to another.

Walter: I don't talk with many very academic, statesmanlike people, as Dean knows. But one of my friends says that we'll have to fight inflation and deflation at the same time because what we have been doing so far is analogous to giving somebody who's hooked on heroine a hit of cocaine as a "cure."

Dean: What I guess I said to Walt and Mark last October – at least Walt has repeated it several times – is that *this is not your father's recession.* I was drawing on the fact that over the course of the last two or three years, quite a few widely known economists, whom I will let stay nameless out of respect, have said to me, "The numbers that I've been using and the relationships and correlations that I've used in the past between economic conditions and financial markets aren't falling into place the same way they used to." And they've gone on to tell me, and I'm quoting these economists here, "I'm beginning to get a little agnostic about what's going on and I'm beginning to get a little agnostic about my ability to put these new pieces together that don't seem to fit the same way they used to."

So you decided to look for new ways to put things together?

Dean: Well, keying off those thoughts which imply humility – something which doesn't occur to many of us often – we've got to look for some new relationships. Of course, I admittedly have a propensity to try different approaches. You don't often use contrary opinion, but when you *do* use it *and use it correctly*, it is *extremely* useful. Likewise, you don't often use complexity science, which is essentially the dynamics of arranging a number of things to occur simultaneously and studying them together rather than in synthesis. But I suggested, let's combine all of these pieces together and see if we can come up with something. We thought the world was going off in one direction while most of the investment community continued to be quite confused by the fact that the U.S. economy

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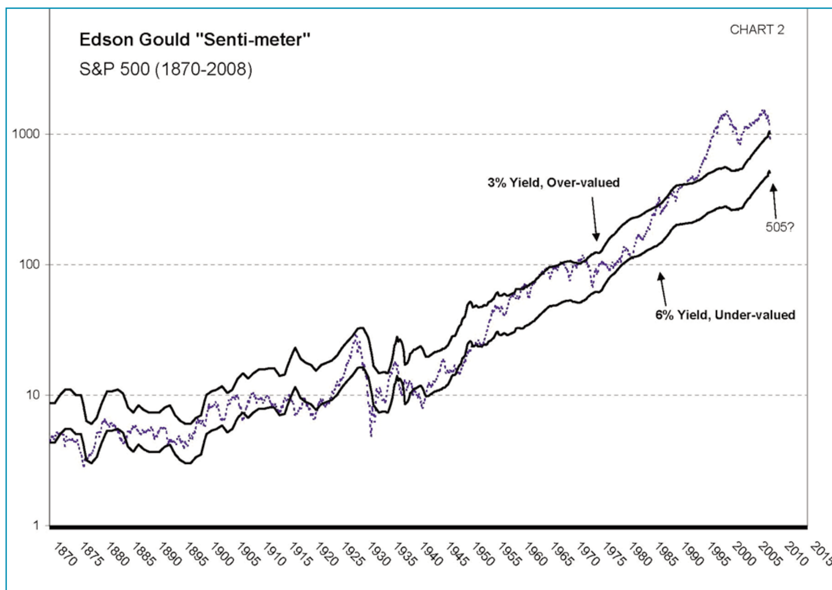


seemed to be in a frozen stop. And the world economy was not behaving differently in any way through it all. It was almost perfectly correlated.

Yes, all correlations went to 1.

Dean: The U.S. currency was the mainstay of everything around the world, as we all know, and yet we were losing other people's money. I live for part of the year in Switzerland, and the Swiss have been saying to me for a couple of years that they thought what was going on in the United States was so bad that they should quarantine the U.S. so that they didn't get the disease. Well, they *did* get the disease; they didn't quarantine the U.S. But for the Swiss to say something like that suggested, to me, that there were some severe forces at work. And that they weren't just ordinary structural forces, like an imbalance between inventory and sales that you would see in a normal recession, where you would sort of take a pause for nine months while they got caught up. It suggested to me that there was a lot more going on and that we should look at behavioral finance and examine the degree of confidence in the world's financial systems from fresh perspectives. Then again, it came down to the fact that Walt and Mark were good soul mates in discussing all this in October and out of those conversations grew the paper we sent to you. [Available at www.walterdeemer.com/A_Way_Forward.pdf] We simply decided, let's write something because we think we have something different to say.

If this isn't our fathers' recession, what is it? A depression?

Dean: We don't even know how to define depression. There's a prediction market that I follow, and Walt does, too, at www.intrade.com, which attempts to measure the likelihood of things like a depression or a recession by tracking how much people are willing to bet on one outcome or another. You essentially put money down on one outcome or another. The last forecast I looked at – which is a couple of days old – was that the chances for a depression occurring in 2009 in the United States was about 65%. That number is outstandingly bad.

It sure is. How does intrade.com define "depression"?

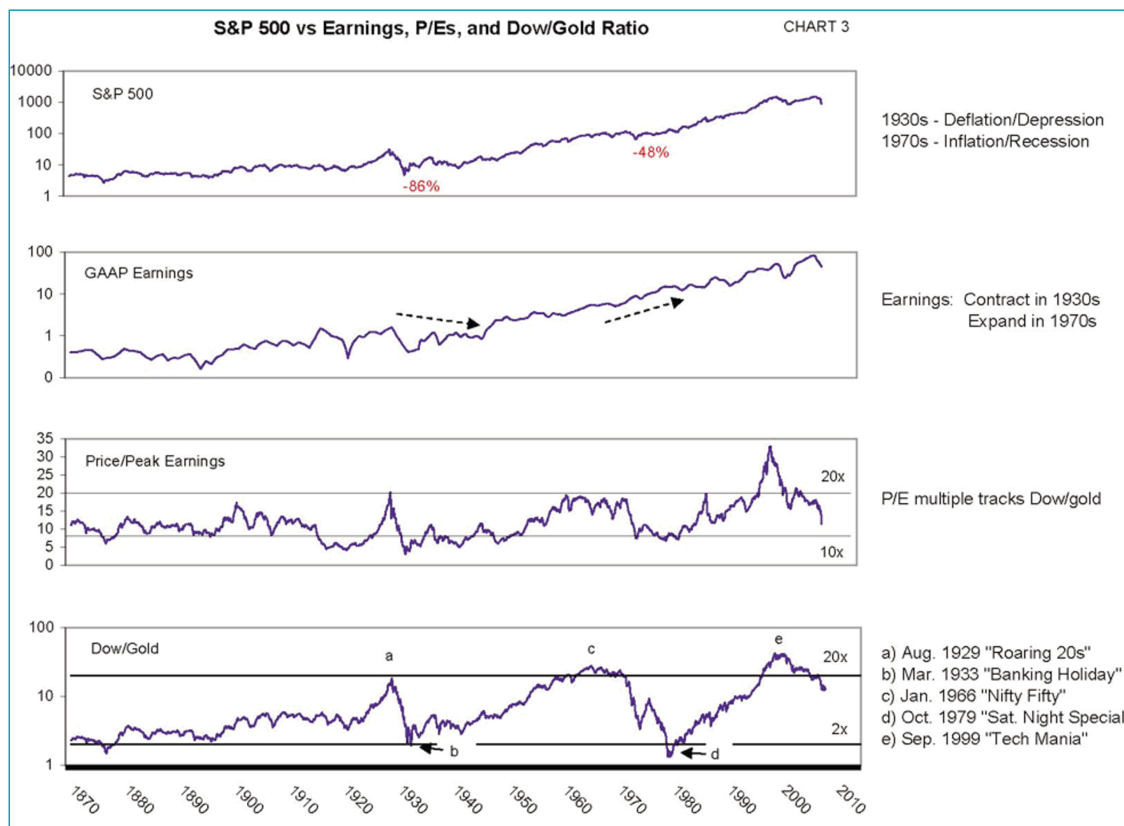
Dean: Well, Walt has correctly argued that the definition of a depression is something we don't really know very much about. We haven't had enough of them. And Walt doesn't like the way intrade.com defines depression – and I agree with him. They have defined it as a 10% decline in GDP during calendar year 2009. Walt points out quite correctly that GDP has already declined by something less than 10% but more than 5% in the fourth quarter of 2008. So it already had started down the slippery slope. Which means defining it as a 10% decline within the confines of calendar 2009 is not a great way to measure it. Merely the discussion is interesting, however, and goes to show that there really is no widely acceptable definition. There is, in contrast, an accepted definition of recession because we've had so many of them. Depression, we don't know anything about, which from a contrarian standpoint is a very nice hint that maybe there's some merit in thinking about it.

Mark: I'd like to interject some historical perspective on the definition of a depression. In the course of my research for our paper, I was reminded that when people talked about the "Great Depression" before 1939, they were referring to the period from 1873 to 1895. People's perceptions very much play into the labeling.

Or vice versa. "Recession" was the euphemism they came up with after the 1930s to avoid scaring folks.

Dean: Yes, the assumption is that we can have an economic decline now, which we're having, but that we know how to solve economic declines. We solve them with some combination of monetary and fiscal policy. In our case, right now, we're using massive amounts of

both. That's the old Keynesian notion and most working economists don't dare to be anything other than a Keynesian. The assumption is that it's something we know how to do and we know how to do it fast and so we will do it. But what we're saying is that it may either not work or actually be harmful in terms of inducing monetary instability later.



Monetary instability?

Dean: Yes. On an international scale. There are a number of countries – Switzerland, among them – who have been saying that the international monetary system is too dependent upon the United States. And they may try to use this interval to try to figure out how they could become less dependent upon the stability of the U.S. dollar.

You see this an opportunity to overhaul the international monetary system?

Dean: Yes, the system certainly could use an overhaul. But the question is whether we, as Americans, would like to have the overhaul done *to us* or whether we, as Americans, would like to be leading participants in the overhaul. Those are two very different things.

I can't see the U.S. standing by passively—

Dean: There was an international meeting on monetary conditions roughly a month ago, which didn't amount to much more than a photo opportunity. The next one is set for late April. But I hear stories every once in a while that other monetary meetings, in which the U.S. isn't included, are going on. I don't know whether anything will come of them, but I would much rather have the U.S. be a participant in the solution.

Yet you said earlier that you're afraid some of the policy moves being made will only make things worse?

Dean: That's right. I mean most people who have been in government for a while – and I was, for little bit – are extremely sensitive to the idea that they exert leadership. The one thing you can't do is to say, "I don't know." An example I've often used comes from the first chapter of the management manual for officers at Annapolis. It says that if a decision comes to the captain on the bridge, the main thing for him to do is to be decisive. It doesn't much matter if his order is full speed starboard, full speed ahead or whatever. Because if there was a reason for making the decision on the basis of facts, it would have been made *before* it came to the bridge. We are somewhat in the same situation today; People are exerting leadership right now and no one wants to stand back and say, "Hey, wait a minute, we'd better think this through carefully."

Gee, just because the likes of Bank of America and Citigroup keep coming back to the taxpayers for more bailout money?

Dean: They are prominent examples. We make a plea in our paper for transparency. We don't have the data available to us to tell us about all of the loans that are out, even though we have put a whole lot of taxpayer dollars into them. I would make transparency a condition of receiving bailout money. I don't mean that you have

to have all decisions made by the government or that we need lots of new regulations. But I want more data on what is being lent and what is being done with it. If anything, it looks like we're actually getting less data. The Bank of England has just announced that it will no longer publish weekly figures on how much extra money it is printing. In this country, for more than a year now, the government hasn't published statistics on M3. So we're actually getting less data, rather than more, perhaps because it might lead us to conclusions that the government doesn't want to gain currency. Anyway, I'm a strong proponent of transparency instead of regulation. With transparency, the end markets can find their own balance. Yet at the moment we may be getting less transparency amid pleas for more regulation.

Mark: I would add that the things that we are doing, because our leaders feel the need to "do something" are likely to work with long lags. So we don't know the consequences of these interventions will be. I mean, the credit crisis really started in early 2007, and yet, while the stock market topped out that October, it didn't really reflect the crisis until last fall. And the stock market is supposed to be a *leading* indicator?

Dean: Well, markets and the economy have, for the last two or three years, been gradually pulling away from one another. Historically, yes, the stock markets led the economy but were correlated to it. The market had its cycle, which led, by about six months, the business cycle and everything moved along in time. And the intended purpose of the markets was the efficient allocation of capital to business enterprise. But over the course of the last several years, maybe five years or so, the markets and the economy have seemed to be moving apart. The markets have become their own beasts. Certainly, derivatives on oil and the like seem to have rather little to do with the production of oil but a lot to do with the production of derivatives.

Likewise, credit derivatives.
Dean: And credit derivatives as well. If you break them up, they have nothing to do with what is underneath. I'm old enough to go back to my old **Graham and Dodd**, which is where I learned about debt. According to *Security Analysis*, the purpose of debt was project-related and debt was to be paid off from the profits of a particular project.

How incredibly quaint.
Dean: It's extremely quaint. The idea of the rollover of debt, when I first worked umpteen years ago, was seen as very strange. The idea that debt would become a permanent fixture on the balance sheet, or that you could break it apart and never put it back together would have been considered very weird.

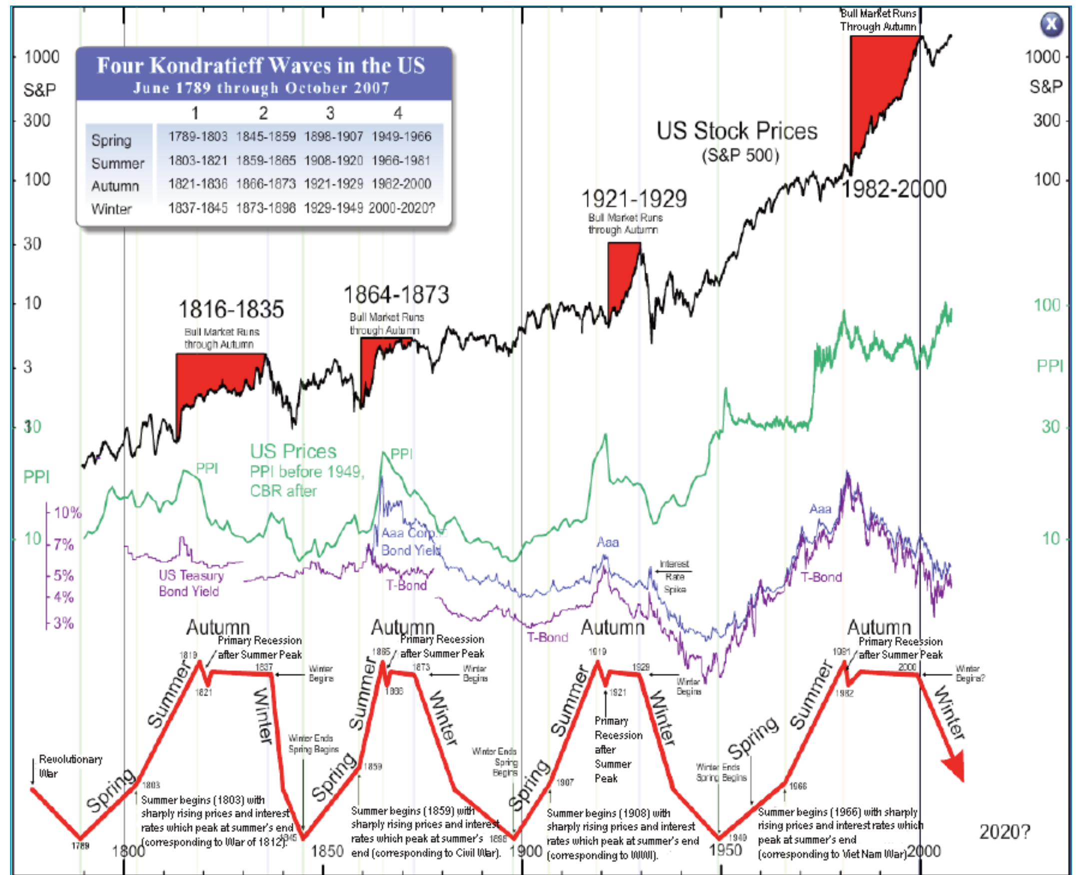
Mark: Nixon made currency irredeemable in 1971 – at about the same time that **Walter Wriston** started talking about managing the liability side of the balance sheet, and since then we seem to have evolved liability management all the way to the consumer, in terms of credit card debt.

Dean: From where I sit, we seem to be in something of a "through the looking glass" situation. We may be putting something back together. But it's the old story, we're looking through the glass and there's another world on the outside. And we don't have the tools from our experiences of the last couple of decades to understand what we may be getting into. Yet those are the sorts of tools our society is designed to depend on.

You mentioned some alternative tools, however, in your paper —
Dean: And those unconventional alternatives were why the paper was rejected by FAJ.

They definitely don't fit into value-at-risk models, then again, VAR analysis hasn't exactly covered itself in glory.
Walter: Part of the problem is that all of us, but especially technical analysts like me, deal on past experience and none of us have lived through something like this before. Even our elders haven't lived through it before. So we don't have experience to go on or to. During the Crash of '87, you could go back to the Crash of '62. During the unwinding of the technology bubble, you could go back to the unwinding of the Nifty Fifty bubble. But in this situation, you have to go back to the 1930s to find some similarities. And anybody who was around back then and is still with us was in a crib in the 1930s. So we are all learning for the first time and that makes it a little tougher.

Not to mention that many modern analysts simply can't conceive of going back that far, because the data sets on their computers stop well short.
Mark: I actually would go back even farther



than the 1930s, but I have to say that I start to lose some of the historical context when I go back generations – unless I'm simply not digging hard enough.

Dean: We joke that Mark doesn't talk to any living economists. He only talks to the dead ones.

Mark: They can't shoot back.

Dean: But I talk to the living ones. It's one of the reasons we mesh well together.

Mark: I like to think that if Keynes were alive today, he would not be a Keynesian.

I'll bite, why not?
Mark: Because he was dealing with the times in which he lived. He was very brilliant, very clever, as well, and he also famously said he changed his mind because "the facts have changed, sir." And because I think what are known as Keynesian economics have been corrupted or politicized over time.

Dean: Keynesian economic solutions have been overused. They have been applied five or six times since World War II, and the seventh time, we may discover, they will have no effect.

Mark: Right. This time, only if the answer to too much credit is more credit, can the Keynesian be right.

It does seem like prescribing "a hair of the dog that bit you" to cure a hangover.
Mark: Well, you can argue that FDR's Keynesian policies shocked us out of a situation where the gold standard probably had gone too far and probably had itself become harmful. So Keynesian policies, back then, were able to shock us out of a self-feeding problem. Similarly, when Paul Volcker dramatically raised interest rates, he was able to shock us out of another set of self-feeding problems. But nobody is talking about anything policy-wise, that would be similarly painful or wrenching or shocking here.

We need somebody to hold paddles and yell, "Clear!"?
Mark: I don't know, but I am skeptical that more of the same is the answer here– and I think Dean and Walter would agree.

Dean, you publish something called the *Complexity Digest* and consort with scientific theorists who write on levels that addle my brain. What are they saying about our fine economic mess? This foundering financial system was allowed to become far more complex and convoluted than almost anyone realized during the credit boom. Yet the "solutions" being proffered are pretty linear, whether Keynesian or Austrian.
Dean: This is a perfect application, if there ever was one, for complexity science. But unfortunately, the few complexity theorists who are economists are engaged in other things; distracted for one reason or another. So there is nobody whom I know of who's really doing a good job of studying this, at the Santa Fe Institute or elsewhere. It's too bad because it is a dynamic problem; it's an interesting one and it's one that complexity theorists should have a lot to contribute to. I can only do it in the most superficial way possible, by saying that and trying to encourage a few friends to spend some time on it. But they're engaged in other things and don't see any way in which the policy makers would do anything with their

research, anyway. Of course, that *shouldn't* be a deterrent. Anyway, this is a perfect example of a mixture of a structural problem, an international problem and a behavioral finance problem all mixed up in a stew that should be dealt with together, so it would be perfect as the subject of a convocation or conference of complexity theorists. But as far as I know, none is planned.

It sounds like a failure to engage with the real world to me.
Dean: Yes, I think so. And the failure is mine. I've tried to stimulate something, but I haven't been very successful. But it should be done because we should be playing chess rather than playing checkers.

Among the things that tell you that, you pointed out in your paper, are the volatility extremes we've seen in the market? Walter, I assume you did that technical work —
Walter: I did the digging and then Mark did the interpreting. He may not admit it, but Mark is a gifted technical analyst.

Mark: I'm proud of it; it's the only way I can make any money. There are many ways you can look at volatility, but they all show pretty much the same thing. What we wanted to show in the chart [page 1], though, is that while elevated volatility is clearly a bear market phenomenon, extremely elevated volatility is not an unambiguous signal. That's because the most recent example (before last year) of extreme 20-day volatility on our chart was in 1987, which was at the beginning of the Greenspan era; when he first got into the practice of "liquefying" a crisis. And that volatility, and crash, we know in retrospect, were "just" cyclical corrections, dramatic though they were, in what was still a very young secular bull market. We also looked [in the table inside the chart] at the market's volatility expressed as a standard deviation of daily closes in excess of 5% over an average trading month. It was striking that the autumn 2008 decline had 12 days with greater than a 5% move, either up or down, in the Dow Jones Industrial Average, versus 11 of those days in October, 1929.

You also looked at some other market cycle indicators that have long been all but forgotten—like Edson Gould's "Senti-meter."
Mark: Yes, and later we point out where we in things like the Dow/gold cycle and where we are in the Kondratieff cycle. We can go into all of the details, but the bottom line is that the market has given us a behavioral signature that, to be very honest, is very similar to the initial decline into the 1930s bear market. As we acknowledged early in this conversation, it's very dangerous in markets to say, "It's different this time." On the other hand, we started our paper with that quote from Bob Farrell about history not repeating, but behavior doing so. Which is why we wanted to look at these behavioral signatures in the market.

Dean: And we reached back a little bit farther than most people have been in the past year or so.

I'll say, *Edson Gould*.
Mark: Did either of you know Edson Gould?

Walter: I did. When I worked at **Manhattan Fund**, **Gerry Tsai** was very taken with Edson, so he sent the other technician and me downtown one afternoon a week so that Edson Gould could explain all his stuff. So not only did I know him, I was taught by him.

Mark: He evidently got an awful lot of mileage out of his "Senti-meter" model [chart, page 4]. Am I right?

Walter: Yes. It worked really, really well until it stopped working in the late 1990s. But that was after he'd died, I believe.

It stopped working when the S&P blew way above its channel, and it's only recently come back to touch that long-term channel's top again. Kind of makes you wonder where reversion to the mean will take it. Your chart says 505 would only be the bottom of the channel.
Walter: Yes, the problem with reversion to the mean is that the mean is an average of a high and a low. So when you revert to a mean, that doesn't mean you're going back to the middle of a range and stopping. The mean is halfway between a high and a low or halfway between a whole series of highs and a whole series of lows, so the risk is not reversion to the mean but reversion to the lows.

Exactly. Overshoot to the upside, then overshoot to the downside and the mean is the middle.
Walter: Yes, except everybody is yapping about reversion to the mean rather than to beyond the mean.
Mark: Are you suggesting, Walt, that Gould's band changes as it moves?

Walter: No, I'm suggesting that the mean is between 3% and 6%, so you're not likely to stop at 3%; the odds say you're more likely to stop at a 6% yield.

Mark: You also can come back to common sense and say that a 3% yield is arguably a minimum hard yield acceptable on a residual claim; a yield that's a real return of capital. The thing is that in the 1930s, the S&P went a hell of a lot farther down. When I looked at that data, I also noted that the dividends were also declining back then. Which is why it's worth explaining that the 505 level we have marked on that chart would represent a 6% yield *if dividend payouts remain unchanged.* But in the 1930s, they didn't, of course. Payouts, if I recall correctly, declined by a third.

Hardly surprising, considering what was happening to earnings. So Gould's chart tells you—
Mark: Look out below.

Which I take it is also the message of your Dow/Gold chart and your various S&P valuation charts [page 5].
Mark: Right. As you know, the Dow/gold ratio measures how many ounces of gold it takes to buy the DJIA (currently 12) and, according to its followers, reveals long pendulum swings between financial asset and hard asset eras. One interesting thing about the Dow/gold ratio is that you can see that – even if you'd been trying to interpret it in real time – back in 1987 it could have given investors real help in navigating the astounding short-term volatility experienced in the Crash.

How so?
Mark: Well, you can imagine what people were thinking in 1987. They had this volatility that hadn't been seen since late 1929 and, at the same time, the P/E ratio was as high as it had ever been, which was 20.

I don't have to imagine. I remember it well.
Mark: Well, if you would have looked at the Dow/gold as a proxy for valuation, you would have found reason to doubt that the top was in. It was only at a five multiple and you would have seen that prior cycles had gone much higher. So recognition of a rising Dow/gold phase could have helped keep investors in the still-young bull market. By the same token, today's investors should be very cautious because recent volatility has taken place in a Dow/gold downtrend.

Dean: There's one measure we didn't put in our paper which may be among the best of all as a market forecaster, and that is the number of people engaged in financial services. The number of CFAs, right now, is approximately 100,000 around the world. The total is growing faster globally than in the U.S., but the last number I saw had it still growing on the order of 18% annually. We have yet to see any substantial decline in that number, as far as I know, but I assure you, we will see mean reversion in that series, too, to a lot fewer than 100,000. That may end up being one of the best indicators to watch.

Walter: How many fewer 100,000?

Dean: I don't know. But services in the United States now contribute about 45% of GDP. That number is going to be a lot less than that because we can't all be providing services.

Walter: Would you like to repeat the number that you mentioned to me at the *Contrary Opinion Forum*?

Dean: Go ahead. I've conveniently forgotten it, but you evidently haven't.

Walter: Well, you predicted that the total will be cut in half.

Dean: That's a modest forecast. I'll stick with it, sure.

Mark: Why not? Have you heard the bad joke circulating among traders about what CFA stands for now? "Can't Find Alpha."

That's pretty good. But I like the name they quickly came up with for the combination of Shearson and J.P. Morgan better—"Citi-Morg."

Mark: I'm writing that down.

While we're on dark topics — whatever moved you guys to add a discussion of Kondratieff wave cycles to your paper?
Walter: No discussion of long-term market cycles would really be complete without delving into Kondratieff-wave theory, even if it is pretty well shrouded in mystery because its creator, Nikolai Kondratieff, died at age 46 in a Russian gulag. That was in 1938, when Joseph Stalin at the peak of his power and Nikolai make the mistake of predicting that capitalism would, once again, revive and flourish.

Dean: He was a real victim of the sort of "career risk" everyone in Wall Street worries about these days.

But why get into Kondratieff waves? Most modern economists tend to sniff that K-cycles are unscientific and wide open to vastly different interpretations.

Walter: We make a point of saying that we remain skeptical of the theory as market practitioners but find its descriptive power interesting at this juncture. We believe that its descriptive power is more important that its lack of timing precision.

Mark: I'll be a blabbermouth. Obviously, it was written in Russian and it really wasn't written to describe the stock market.

Dean: It was written to describe commodities cycles back then, because economies in his day were agricultural. But basically, we think K-waves deserve attention as an interesting historical construct. And we point out that dismissing them as unscientific hasn't helped economists avoid repeating historic mistakes.

Walter: One stumbling block for economists has been that as originally postulated, the Kondratieff wave was a generational phenomenon. But maybe it is really a lifetime phenomenon. If so, the longer life expectancy we have now, compared with the 1930s, may be what has apparently lengthened the old 50- to 54-year timeframe of a K-wave cycle. Maybe we're not likely to repeat the excesses of earlier generations until we lose the personal guidance of those who lived through the last K-wave down cycle.

Dean: It's not in any sense a precise tool; as K-waves go from one phase to another the pacing is not absolutely exact. But it's a helpful descriptive tool as to what kinds of things you might be looking for when you think that you're at a shifting point from one very long term phase to another. When you look at the chart [page 7], you can see that the financial markets are doing something unlike anything we have seen since the 1930s, and that we are likely working our way down to a Kondratieff trough. In K-wave terms, we are moving from Autumn to Winter. Just as the current decline is unlike the declines of the past 60 years, the ultimate bottom is not likely to resemble the bottoms of the past 60 years, either. This, in turn, means that the next bull market is also not likely to resemble the bull markets of the past 60 years. So this is not your father's bear market, just like it's not your father's recession.

Mark: I have to say that I used to be somewhat dismissive of K-theory, because I didn't feel I could trade it. But the more I've worked with it and contemplated it, the more I've discovered that it does open your mind to potential outcomes that you wouldn't otherwise be open to. It's unfortunate that it's regarded as a bit of a third rail in the industry.

Dean: Well, one of the things that we'd hoped to do if the FAJ published our paper – was to open up pathways to look at data when it is considered very dirty (as in, before the 1930s); open up pathways for exploration. As Walter said, very few analysts using conventional tools, had any idea this crisis was coming. The long term cycles we explored all have one thing in common: a message that the ultimate lows in this cycle may be considerably lower than November's scary lows. Based on the historical evidence, what's more, we are likely to experience either painful debt deflation or highly destructive monetary inflation– and perhaps both at the same time. (Yes, it's possible to have deflation from asset destruction on a monumental scale at the same time as inflation from the ultimately successful increase in the money supply engineered to combat the deflation. Tools to fight the negative effects of one may aggravate the downside of the other.) Meanwhile, we expect governments to continue to follow the seemingly easy path of heroic intervention until forced to confront the issue of sound money.

What you're implying, then, is that we're facing not merely a winter of discontent, but several winters of discontent?

Dean: The artful tool of the Kondratieff theory actually gives us guidance that the decline might last another 5-10 years – or longer. And meanwhile, we question whether government intervention, which works in batch-processing time, can fix major structural problems in markets that adjust in real time. We worry, too, about interventions that could undermine things like fundamental property rights, international cooperation and personal freedoms that were crucial to capitalism through much of the 20th Century. I haven't kept very close tabs on this, but my impression is that almost every time we have announced a stimulus package or an enhancement of a stimulus package, the U.S. stock market has gone down. Now, you might say that the markets have already discounted the news, but there may be something else going on. We might be doing something harm-

ful in those stimulus packages – and that is what the market declines could be reflecting.

Mark: This gets back to an earlier point Dean was making. There seems to be almost a cavalier attitude on the part of policy makers. They're not worried, as we are, about unintended consequences. Just imagine how different it would be if a policy maker sat down and started with the idea that this may be a long-term situation – and that whatever he does might make it worse. Somebody *should* be worried about the consequences of these interventions.

Are you suggesting that Washington should have just stood back and watched the credit system ice over?
Dean: No. We're not *that* Austrian. But we don't think tired Keynesian prescriptions will work either. To repeat, we need to play multi-strategy chess, not checkers. I can't speak for Walt and Mark on all of these points – and even we don't claim government policymaking as a core skill. But if pushed, my Rx would include 12 or 13 elements: 1) Targeted spending, a negative sales tax and government participation in new loans. 2) An open invitation to foreigners to invest in the U.S. 3) Transparency everywhere, but especially where government money is spent or lent. 4) Having the Treasury borrow in foreign currencies now, before we have to. 5) For its symbolic import, dedicating ourselves to an advance paydown on foreign debt. 6) Putting the government, wherever possible, on a payment for service basis. 7) Cutting the defense budget by 50%. 8) Promoting international trade to blunt the growing anti-trade sentiment. 9) Eliminating agricultural subsidies. 10) Forgetting ethanol. 11) Reorganizing the UN with teeth. Bring Brazil and India into the Security Council as permanent members. 12) Signing the Kyoto and International Court treaties to signal internationally that there really is a new administration in town. 13) Realigning the monetary system to create backing for the U.S. dollar along the lines of the trade-weighted Singapore system.

Those are some mighty tall orders.
Dean: Well, the first thing government policy should do is do no harm. That's where transparency comes in. If we want to give some bank $25 billion, we should do so at the price that they completely open their lending books. That way, the market would be allowed to assess the risk and the reward. It's interesting, **Bob Schiller** says that the real estate market overall is approximately 40% overpriced now, in relation to national income–and national income is falling. Well, if that be true – and it doesn't sound like bad analysis to me – then attempting to stop foreclosures at this level is a mug's game. The market has got 40% to drop, just to get to even. Trying to hold it here artificially just can't work.

What would you do instead?
Maybe even something as wild as buying up housing stock that is likely to be foreclosed and turning around and renting it to the occupants. The United States is one of the very few countries that predominantly has owner-occupied housing. In Switzerland, for example, very few people own their own houses. Almost everybody rents.

Mark: Trying to revive the market that was the problem, if it has gone to an excess, is usually hopeless.

Walter: There was that famous attempt during the Crash of '29, when the bankers' pool came in and started bidding for stocks. It stopped the declines for an afternoon and that was it. Then the prices went to where they were going to go.

Mark: Right, despite statements from John D. Rockefeller that sound a lot like the ones Warren Buffett was making back in October or November.

So Humpty Dumpty is kaput; nothing is going to bring back the Goldilocks environment of the late bull market and billions or trillions of debts have to be liquidated?
Dean: I am afraid so. I do have a crazy idea, if you want to stimulate consumer spending, which I'm not sure is a great idea here. I do think too much consumer spending, and debt, were parts of the problems that got us here – and added to the trade deficit. But if you did want to stimulate spending for a while, the government could institute a negative sales "tax." Just reset every cash register in the country to add a subsidy, instead of deducting a sales tax, on each transaction. Again, I'm not sure it's a good idea in our present circumstances, but it would be a more efficient way to encourage consumer spending than income tax rebates.

So suppose President Obama called and asked you to help rescue the Treasury—
Dean: We'd have some suggestions, although I'm sure we wouldn't agree on everything. I was part of a World Bank group that went to Latin America in the '70s and lectured Brazil and Argentina and Chile about how to behave financially to rejoin the world's markets. We had seven looseleaf notebooks, and we went

through them one-by-one. We were terribly obnoxious.

You didn't start by warning, "Beware of American bankers bearing gifts?"
Dean: No, but we should have. They were very polite and listened, even though a lot of the advice that we gave them was contradictory. I mean, we said pay off some loans to demonstrate that you are aware of the importance of fiscal prudence. But you can't pay them all off. Tighten up your economy but at the same time, stimulate through government projects and clean up corruption and improve transparency. How often have I thought that those prescriptions for Brazil should have been applied to the United States, as well. Brazil is in much better financial shape today than we are.

Thanks very much to the commodities boom.
Dean: That's right. It was serendipitous, to be sure.

Transparency is a lofty goal, Dean. But Wall Street always wants it limited to the other guy.
Dean: That's true. I'm horrified by the idea, by the way, that there are all of these so-called dark pools. Where, essentially, 20% of all stock trades take place but never get reported, anywhere. There's no history on them. It is utterly contrary to the things that I believe about how you should have price discovery over a period of time. We have been moving away from transparency in the equities markets.

Trying to match, perhaps, the opaque nature of the credit markets, where people blithely placed billions of dollars of derivative bets in "dealer markets" in which they were essentially making side bets with the croupier.
Dean: All of that has to be cleaned up. But you know, poor old **Chris Cox** has been beaten up for being a bad SEC Chairman. But that's not true; he did exactly what he was told to do. The admonition was, "Now, Charlie, you sit here for a couple of years but don't touch anything."

True enough. But "I was just following orders" isn't a defense.
Dean: I'm just pointing out that it's too easy to find scapegoats instead of fixing the structural problems that got us into this mess.

Mark: I don't have expertise here – but I suspect you will see major reforms of the over-the-counter derivatives markets. Exchange-traded derivatives have a pretty good track record. Margin clerk works pretty well, as do standardized contracts. Besides, how many derivatives contracts do we need? I have all the risk I can handle in the cash markets.

But that was the beauty of it all, the derivatives provided immense leverage and were supposed to hedge those risks into oblivion.
Mark: Even better, the over-the-counter derivatives could be kept off balance sheet, so there was all sorts of room for nonsense in internal marks and valuations, because there were no margin clerks.

Walter: See, these are the problems we are trying to get our hands around with the Kondratieff analysis. What we are saying is that the markets go from wild and woolly, unregulated, to a clamped down and heavily regulated. You can't quantify exactly how wild and woolly they got, but we know they were wild and woolly, and we also know the pendulum is swinging the other way. The same thing happened in the '20s and '30s, when we swung from wild, woolly markets to the formation of the SEC, and all sorts of other regulations.

So you're not at all sanguine that we've put in a bottom?
Walter: The rule is that financial stocks generally bottom and start generating relative strength before the market bottoms, which we obviously have not seen yet. That's the scary thing.

You've been skeptical of the November "bottom" pretty much all along —
Walter: That's true. And the fact that some of the key bank stocks are breaking their November lows is not a good sign.

Dean: On another level, the close cooperation we've been observing between the Fed and the Treasury isn't really a good thing. Central bankers around the world like to think of themselves as very separate and independent of political influence. When they meet monthly in Switzerland under the auspices of the Bank of International Settlements, they almost always grouse about having to correct for mistakes made by their governments. If the U.S. Fed starts to be seen as the Treasury's partner under Bernanke as it was under Greenspan, its position among the other central banks will be compromised. Foreign central banks will be less likely to speak openly, and less likely to cooperate with the United States at the central bank level.

If October demonstrated anything, it's that we need far more coordination and cooperation in international finance. And quite possibly a new international monetary regime.

Dean: Right. It's very unfortunate that the U.S. Fed is the only central bank with a combined mandate for both monetary stability and economic growth. The other central banks only target economic stability.

You make no bones in your paper about harboring some Austrian leanings and do call for monetary reform, but not for the classic Austrian solution of a gold standard?

Mark: We're not that cynical. We believe that people will use fiat money. We aren't Austrian economists, however interesting and useful we find some of their economic principles, as investors – things like it's the boom that causes the bust; the bust is proportionate to the boom; major intervention is likely to cause major unintended consequences and that sound money is always the preferable policy. The problem with the Austrians, from my/our perspective is that many of them are too rigidly dogmatic: No inductive reasoning; no fiat money; no fractional reserve banking.

Dean: As practical investors, we'd rather pay less attention to lofty principles and more attention to what is going to work. The attitude of the world toward the U.S. too long has been one of disdain for its aggressive and self-destructive monetary policies. Now, with new leadership, there will be a new assessment. I am worried, though, that expectations are vastly too high.

Isn't some disappointment natural, when the honeymoon wears off?

Yes, but I'm concerned that in this case what will follow is a drive for "anything but dollars" on a global scale, a drive that the U.S. won't be able to control. I can see global system being imposed upon the U.S., in which each country supports its currency by holding reserves in proportion to its trade balances – something akin to what Singapore does today. Should that happen, you'd have to hope that Kondratieff's Winter is not an icy blanket of "beggar thy neighbor" protectionism. But that seems to be coming to the fore in a number of advanced countries and even gaining political popularity in the United States. If so, the Winter could be a decade or two long. To forestall that, I hope to see the U.S. taking a generous step forward, and asking its trading partners, "What can we do to help you with your dollar problem?" At the moment though, very few people in the U.S. are acknowledging that the rest of the world has a major stake in how the United States solves its currency problem.

Mark: All the talk here is about granting forbearance, when we really need to *seek* forbearance.

Dean: Exactly, and that's what the other countries are saying. They're saying, "The new U.S. administration says it will listen, but we don't hear you asking the question." Granted, it's early yet, but I don't see **Larry Summers**, for example, talking to his counterparts in other countries. It will be very interesting the first time that the U.S. has to borrow money in something other than it's own currency.

Mark: Shocking, you mean.

Dean: Yes, which is why I'd be inclined to do it on a voluntary basis, before we are forced to do it because no one shows up at a Treasury auction. I don't see that as likely, but it would really send a message to the rest of the world that the U.S. is ready to take the risk of somebody else's currency the same way they have been taking a risk on ours for the last 25 - 30 years.

That *would* be a show stopper. Let's close on a more practical note, though. Walter has been counseling caution and holding insurance for some time. What are you doing, Dean, to try to cope with all of this as an investor?

Dean: My recommendation is what I call a dumbbell strategy. Gold on one side and cash on the other side. One of the two will be right and, hopefully, both sides are mispriced in relationship to what the actual risk and return are likely to be. It's a complexity portfolio strategy where you're doing two things in roughly equal balance; one side is wrong, but you don't know which one. And the name, dumbbell, applies to both the strategy and the originator.

***Right.* Thanks, gents.**

W@W Interviewee Research Disclosure: Dean LeBaron is the founder and former chairman of Batterymarch Financial Management. Walter Deemer is a technical analyst who has published "Market Strategies and Insights" since 1980. Mark Ungewitter is Vice President and portfolio manager at Charter Trust Co. This interview was initiated by Welling@Weeden and contains the current opinions of the interviewees but not necessarily their respective companies. Such opinions are subject to change without notice. This interview and all information and opinions discussed herein is being distributed for informational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but is not guaranteed. In addition, forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, or as an offer or solicitation for the purchase or sale of any financial instrument. No part of this interview may be reproduced in any form, or referred to in any other publication, without express written permission of Welling@Weeden. Past performance is no guarantee of future results.

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