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*“History often repeats itself, but never
so literally as to enrich historians”*

—James Grant

A Latticework Approach to Inflation

A few weeks ago we stumbled upon a transcript of a lecture given by Charles T. Munger entitled “Academic Economics: Strengths and Faults after Considering Interdisciplinary Needs.” For the uninitiated, Charlie Munger is the crusty and sometimes intolerant (he doesn’t suffer fools gladly) Vice Chairman of Berkshire Hathaway and the reason that Warren Buffett’s son has remarked that his father is the *second* smartest man he knows. Munger was the featured speaker at the Herb Kay Undergraduate Lecture at the University of California, Santa Barbara Economics Department on October 3rd, 2003. The essence of Munger’s talk was the lack of synthesis in economic thinking, or put more bluntly, the dearth of educated common sense (drawn from many disciplines) in arriving at economic conclusions. Munger accused the soft science of “physics envy”. In a quest for precision, the profession measures only data that is easily counted which leads to a “fatal unconnectedness” to what is really going on in the world. Munger is at least indiscriminate. In his lectures he often speaks of a multidisciplinary approach to investing. A “latticework approach”. I first became exposed to this latticework approach to investing and problem solving a few years ago. First, in a somewhat biographical text about Munger and Legg Mason’s Bill Miller entitled “*Latticework-The New Investing*” by Robert G. Hagstrom and then in a biography written by Janet Lowe entitled “*Damn Right!-Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger*”.

To Munger, a study of the sciences, arts and literature is as integral to investment management as the study of finance and accounting. And although we have been intrigued by the latticework approach and use it to the best of our abilities in asset management, our frustration is not with the pursuit of precision in economics but the lack of it when it comes to the aggregation and interpretation of data. How else can one explain the disagreement over the definition of inflation let alone what will cause it, how it is measured and when and where it will be manifested. Recently, in a related matter, we read some very ominous commentary about the sudden rise and subsequent tapering off of the money supply. Monetary aggregates increased at an annualized level of more than 12% of GDP in May and the reasons cited for the rise in the money supply ranged from the conspiracy theory that Greenspan increased the money supply because he knows of

imminent danger, to the mollifying explanation by Stephanie Pomboy of *Macro Mavens* that the increase in M3 was just a normalization of the growth in the monetary aggregates back to long term trend. No big deal. Yet if the truth be told, most of the commentary amounts to nothing statistically but the reading of tea leaves and no one really has a handle on the source and application of these monetary aggregates. If Luca Pacioli (the Italian monk who has been credited with inventing the double entry accounting system in the fifteenth century), had been involved in the development of economics, you can bet that there would have been a national Balance Sheet and Cash Flow Statement to go along with the disaggregated fund flow data that only the descendants of religious philosophers seemingly find workable.

Munger recounted the story of Nobel Physicist Max Planck: “One of the interesting things that I want to mention is that Max Planck, the great Nobel laureate who found Planck’s Constant, tried once to do economics. He gave it up. Now why did Max Planck, one of the smartest people who ever lived, give up economics? The answer is, he said, ‘It’s too hard! The best solution you can get is messy and uncertain.’ It didn’t satisfy Planck’s craving for order, so he gave it up. And if Max Planck early on realized he was never going to get perfect order, I will confidently predict that all of the rest of you are going to have exactly the same result”. *Munger also went on to tell one of those stories for which he is famous, not exactly related to this essay, but too good not to repeat.* “By the way there’s a famous story about Max Planck which is apocryphal: After he won his prize, he was invited to lecture everywhere, and he had this chauffeur that drove him around to give public lectures all through Germany. And the chauffeur memorized the lecture, and so one day he said, ‘Gee Professor Planck, why don’t you let me try it as we switch places?’ And so he got up and gave the lecture. At the end of it some physicist stood up and posed a question of extreme difficulty. But the chauffeur was up to it. ‘Well,’ he said, ‘I’m surprised that a citizen of an advanced city like Munich is asking so elementary a question, so I am going to ask my chauffeur to respond.’”

A couple of months ago I witnessed a lighthearted but thoughtful debate between James Grant of *Grants Interest Rate Observer* and A.Gary Shilling PhD., author of two books on deflation and proprietor of *Insight-Economic and Research Strategy*. The topic of the debate was Inflation (Grant) versus Deflation (Shilling). Unfortunately my notes were misplaced, but there is enough stored away in the gray matter to recall the essence of each argument. Grant started out the exercise by first defining what inflation is and quoted economist Milton Friedman, again, I paraphrase, “Inflation is the excess creation of money and credit, excess defined as the level at which money can no longer be deployed efficiently.” Increase money and credit at a much higher level than the increase in Gross Domestic Product (GDP) for a prolonged period and pretty soon you have a whole lot of money relative to GDP. At some point you have to pay the piper. That’s inflationary. Sell bonds. Shilling politely acknowledged Grant’s debate parameters and then, still politely, dismissed them as he spoke of deflation as a result of technological advances and globalization much like the deflation of the 1800’s (a whole lot of excess capacity but sufficient demand to enjoy cheap goods and avoid real problems-think good cholesterol) and not like the deflation that caused the economic collapse of the 1930’s (income and demand dries up completely-think bad cholesterol). Print all the money you

want. It doesn't matter. Prices are going down. Buy bonds. Confused? You're not alone. The audience made up almost entirely of investment professionals voted at the end of the debate, and it was declared a draw.

As an aside, I picked up Shilling's second book on deflation titled "*Deflation. How to Survive and Thrive in the Coming Wave of Deflation.*" A great read as is his monthly commentary to which we subscribe. However, there is a key point that he makes to support the case for deflation that we feel supports the case for monetary inflation. Shilling feels that the shrinking role of government is and will be a deflationary factor in the future – but we feel that the government never relinquished or reduced its role. It just shifted temporarily from a direct spending role to that of a facilitator, manipulating the masses to take on record levels of debt. Perpetuating a phenomenon that has developed in the last few years, in that emerging markets like China are building capacity for tomorrow at the expense of the standard of living of its own people today, while we are supporting the standard of living of our own people today at the expense of our own future capacity.

The Fed assumed an accommodative policy of artificially low interest rates which encouraged the weak, the hopeful and the adventurous to lever up and do their bidding for them. So we pose the question: Can households deleverage in an orderly manner? In other words, not so fast as to curtail consumption dramatically today, but not so slow as to preclude another record run at debt creation and personal consumption tomorrow. Can trend GDP growth be maintained without the fillip of tax cuts, mortgage refinancing, etc.? Has job growth and capital investment over the last few years been adequate to take the handoff and perpetuate this heretofore engineered prosperity? We think not. Instead we think that the government will have to play a larger role in direct spending as the consumer is levered to the gills and businesses are motivated not by the maintenance of trend GDP, but return on investment. The government will become the borrower of last resort. It is entirely possible, in one scenario of which we have mused, that the federal government, faced with the choice of imminent recession, will opt to spend directly to stimulate the economy. Load this additional spending on to entitlements like Medicare and Social Security, (that can no longer be ignored as tomorrow's problem) and you may have a country that is running deficits the likes of which we have never seen. Not the picture of fiscal health that it once was, the US may be faced with the choice of paying up in terms of interest rates to attract foreign investment or to run the printing presses at full throttle just to buy its own bonds. One does not need to be an expert in monetary economics to see the portent of this vicious cycle. But I digress.

Recognizing the conflict between the informed views of Grant and Shilling and mindful of the observations of Planck, we adopt the ethos of Munger, invoke the spirit of Newton and offer our own views on inflation.

Sir Isaac Newton

Sir Isaac Newton (1642-1727) was a famous English physicist, mathematician and philosopher who formulated the laws of motion. Newton's Third Law of Motion states

that “For every action there is an equal and opposite reaction”. This is music to the ears of one who wishes that economics was invented by Luca Pacioli. You see, economics, like life, is imperfect but truly fascinating, but Newton’s concept of equal and opposite reactions, a balance in the universe, yin and yang, debits equal credits, is something we can hang our hat on. Newton’s laws led to the study of a branch of physics called Dynamics, the study of why and how objects accelerate taking into consideration force and mass. Think of a coiled spring. The greater the force, the greater the stretch. Lighten up on the force and watch out for the equal and opposite reaction, the recoil. Hold that thought.

Ludwig von Mises

Ludwig von Mises (1881-1973) was an economist whose ideology was founded in the Austrian School of Economics. The Austrian school is not an actual place but a methodological toolbox or “school of thought.” However, if it were actually a school, it would have a crest with a Latin inscription that would translate loosely to “no such thing as a free lunch.” Von Mises believed that free markets were only “free” when the price mechanism was the only determinant of economic activity. He and fellow Austrians eschewed government intervention, especially that of central bankers. He argued that central bank efforts to lower interest rates below their natural level causes borrowers in the capital goods industry (we also believe this applies to consumers, take housing for example) to overinvest in their projects. A lower interest rate should be a signal that there are excess savings in the system and that consumers have the adequate reserves to back up new production. That is, if a producer borrows to build a new factory, there is enough savings for consumers to buy the goods and services produced in the factory. Projects undertaken can be sustained. But artificially low interest rates lead businesses to undertake unnecessary projects. This creates an artificial boom which is followed by a bust once it is clear that savings were not high enough to justify the degree of expansion. A central bank equipped with a government mandate, the tools and the will to use them will endeavor to smooth out the effects of the business cycle but in fact they will just exacerbate the problem. It may take twenty years of increasing money and credit and declining interest rates before implosion. And we, as psychological beings, held hostage by our most recent experiences of ever abundant credit creation at ever decreasing costs, may be lulled into a false sense of security at the inflection point, just when our antennae should be up. Make no mistake about it, these central bank actions cause reactions and in the past artificially low interest rate credit booms have been susceptible to deflationary busts.

This brings us to the definition of inflation. Von Mises in “*The Theory of Money and Credit*” defined inflation as: “an increase in the quantity of money, which is not offset by a corresponding increase in the need for money, so that a fall in the objective exchange value of money must occur. Deflation is defined as a diminution of the quantity of money which is not offset by a corresponding diminution of the demand for money, so that an increase in the objective exchange value of money must occur.” Von Mises defined money as “money or its fiduciary”, which we interpret today as the creation of excess credit through the creation of unnaturally low interest rates.

Central banks by their very nature practice inflationism. Their interventions into the markets upset the market pricing mechanism and disrupt the natural order of the economic choices we make everyday. Following Newton's third law of motion, these unnatural interventions or forces are actions that will result in equal and opposite reactions. As the actions become more accelerated and persistent, the effect of the recoil (or regression to the mean of which we write frequently) will be in proportion to the imbalance the unnatural interventions created in the first place. Remember Newton's coiled spring? The initial creation and eventual recoil of these imbalances are the *sine qua non* of inflation, at least, based on the way we look at things here at Quantum.

So what would be an example of these inflationary imbalances? Just suppose that the Fed inflated the money supply at an excessive rate which led to a **deflation** in the level of interest rates, which led to an **inflation** in the level of consumer debt, which led to an **inflation** in the level of consumer spending, which led to a **deflation** in our current accounts balance, which led to an **inflation** in the manufacturing capacity of our trading partners, which led to an **inflation** in the amount of US treasuries acquired by foreigners, which led to an **inflation** in confidence in monetary inflation and government profligacy, which led to an **inflation** in fiscal deficits, which led to a **deflation** in US and foreign direct investment in domestic industry, which led to a **deflation** in the rate of job creation, which led to a **deflation** in the federal tax base, which caused further **inflation** in fiscal deficits, which led to even more **inflation** in the money supply, which led to a **deflation** in the value of the dollar, which led to an **inflation** in the price of imported goods, which led to a **deflation** in personal consumption, which led to a **deflation** in demand for our bonds, which led to an **inflation** in the rates of interest that we pay, as well as an **inflation** in other costs of home ownership such as utilities (energy) and real estate taxes, which led to a **deflation** in the value of our homes (wait...did we say house prices can decline?)..and so on and so on. This is just a miniscule sampling of the myriad permutations that monetary inflationism can create and/or exacerbate. The cycle is continuous and dynamic and must constantly battle the microeconomic factors of supply and demand. The price levels of certain items can be inflated while others may be deflated. So we think that the quote at the beginning of this essay is instructive to say the least. Just because something worked during previous inflationary periods does not mean that it will work today.

So what we can agree with is the definition of inflation as per von Mises, Friedman and Grant. Shilling may be correct in his interpretation of the deflationary effect on the price level of some goods and services, then again he may not. There really isn't any way to know until after the fact. Economics and accounting are equally inept at forecasting. Monetary and credit inflation however, has happened and is happening. And while all imbalances are not created equal, it is in the analysis of the creation and the inevitable regression of these imbalances that may provide the best opportunities in the current environment.

We draw on the unpopular and puritan notion that one cannot have his cake and eat it too. You may have record low interest rates, a strong dollar, record current account deficits

and a strong national balance sheet, but you cannot have them all at the same time. The fiscal and monetary action of our government and the choices of the market will determine whether we deflate money and credit or continue the time honored tradition of political expediency. It should not be lost on the reader of this letter that the US dollar has lost over 95% of its value since the Federal Reserve was created.

In closing, it looks like I managed to write a five page essay without specifically discussing our investment strategy. In my next essay I will detail and graph some imbalances that we are watching and outline our investment strategy to protect and prosper from them. I won't make the same mistake twice of promising a delivery date. Right now, I must get ready to fly out west and visit a nifty little company that we have been building a position in. Charlie Munger once said that there are two ways to make money in the bass fishing business. "You can write books and speeches and give seminars on the trends and techniques and the finer points of bass fishing...or you can catch bass." We make our bones by catching bass. Stay tuned.

Best Regards,

John J. Hughes

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