GRANT'S
INTEREST RATE OBSERVER®
Vol. 33, No. 13d | Two Wall Street, New York, New York 10005 • www.grantspub.com | JUNE 26, 2015

Posterity will smile

On June 16, the editor of *Grant's* delivered a talk under the auspices of Russell Napier's Library of Mistakes in Edinburgh, Scotland. The text of his remarks, including some things that he wishes he had thought to say, follows:

It isn't my mistakes that bring us together this evening—not enough time for that. My topic is rather our collective mistakes. The question I mean to address is how will posterity judge them. Which mistakes—financial ones, that is—will our children's children identify as our most gratuitous?

This will take some soothsaying. It's hard enough to separate good judgment from bad in the moment of decision (obviously, if mistakes were clearly labeled as such, people would make fewer of them). It is that much more difficult to attempt to judge how posterity will rank-order our poor choices.

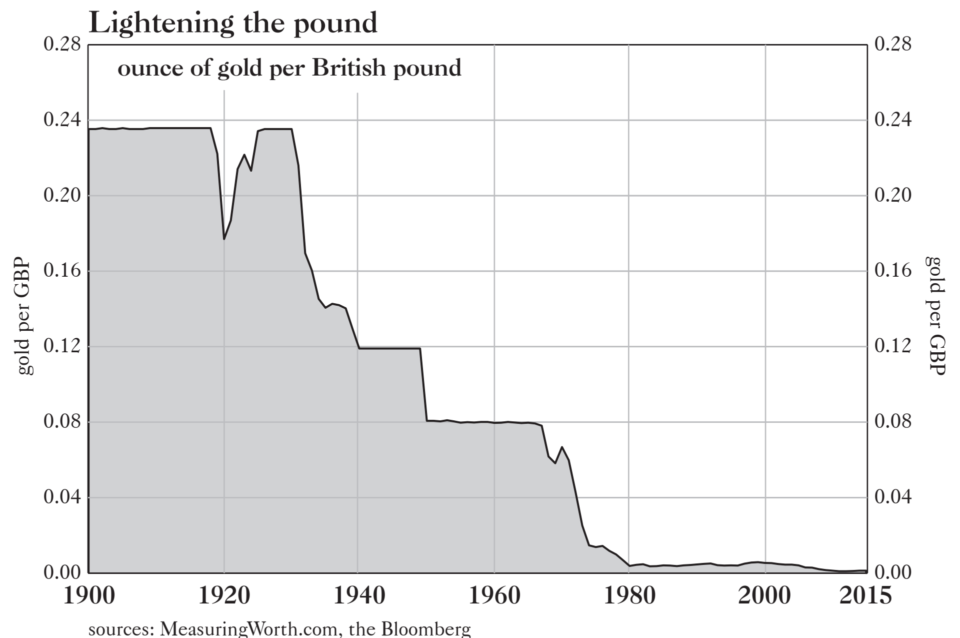
In preview, I am going to put discretionary monetary rule by former college professors at the head of the list of errors over which our descendants will roll their eyes. Deflation-phobia and inflation-philia come next, followed by a general willful ignorance of financial history. Fallen mortals, we *will* err. Reading widely in the words on deposit here at the Library of Mistakes, we could at least err more imaginatively.

You know posterity. You know because we *are* posterity. We tsk tsk at the avoidable errors of the past, or at least at those errors that we judge to have been avoidable. We shake our heads over tulip mania, the South Sea Bubble, the depression of the 1930s, the inflation of the 1970s and the dot-com bubble of the millennium. How could those people—which is to say, our predecessors on this planet in this business—have been so purblind? I propose that futurity will judge our long-running post-2007 experiment in zero-percent interest rates and digital money printing to be just as incomprehensible.

Britain's decision to return to a kind of gold standard in 1925 at the prewar rate of exchange will serve as the historical touchstone of my remarks. John Maynard Keynes argued against it. Winston Churchill contended for it. History—lining up with Keynes and with a very different kind of critic, the great French economist Jacques Rueff—judges the choice to have been disastrous. Whatever your view, the 1925 monetary tussle changed history. It sparked the ideas we live by, which ideas I happen to wish we could live without.

Which ideas might these be? No. 1, that money is an instrument of public policy and not—as wiser heads than ours had long believed—a unit of measurement. No. 2, that interest rates should be administered by the mandarins, not discovered by the market. No. 3, that the consequences of major financial decisions should devolve to the state, not to the individual.

Keynes lost the political contest—Britain did adopt the gold exchange standard in 1925—but won the historical point. Today's central bankers



sources: MeasuringWorth.com, the Bloomberg

treat money like water. They turn the faucet on, and they turn the faucet off—or they *could* turn the faucet off. Whether or not Richard Nixon ever said, "We are all Keynesians now," that phrase aptly describes 21st central banking doctrine. "No standard is the best of all standards" is the lesson that mainstream opinion leaders have taken away from the events of 1925.

Keynes produced a characteristically brilliant attack on the plan to return to gold. "The Economic Consequences of Mr. Churchill," published in 1925, was a comprehensive debunking of post-war orthodoxy. "Sound finance," Keynes ironically called it. In fact, the newfangled monetary arrangements of the 1920s were deeply flawed. With the passing generations, they have steadily become more flawed. Ninety years later, exchange rates wildly oscillate while money-market interest rates lie lifeless at the so-called zero bound. Improvisation is the monetary watchword—"learning by doing," as Ben Bernanke put it.

Up until the shooting started in August 1914, the pound was a unit of measurement—a weight, as its name implies. It was defined as 113 grains of gold. You could exchange your bank notes for gold, and your gold for bank notes on demand—an ounce was worth four pounds, four shillings and 11 and three-quarter pence, to be exact. Because people could make the exchange, and because gold could freely enter and leave the country, the gold value of the pound was evidently inviolable.

The gold standard stopped when the shooting started. Under wartime strictures, no bullion was permitted to leave the country. The right of conversion from metal to paper and back again was suspended. No matter its definition in law, the pound became a depreciating piece of paper. From the start of 1914 to the close of 1918, British prices virtually doubled. By 1925, debt service had become the biggest line item in the British government's budget.

It spoke well of the prewar gold standard that, come the peace, most desired to return to it. The devil was in the details. The City of London, by and large, supported resumption of a new kind of gold standard at the prewar rate of exchange. Captains of heavy industry, by and large, opposed it. A fixed standard of value would be no great blessing at an overvalued rate of exchange—and in a society that had made a political choice that nominal wages should never fall. Then, too, the Bank of England's discount rate would have to be pitched high enough to attract and hold gold, whatever the state of domestic business activity.

A parliamentary currency committee, reporting in 1924, disputed that British prices were out of line with those of the rest of the world. An adjustment of 1% to 1 ½% would do the trick. "[A] courageous policy in currency matters surmounts apparently formidable obstacles with surprising ease. . . ," the committeemen concluded. Yes, they allowed, some temporary rise in interest rates might be necessary. "We are satisfied, however," they went on, "that the assimilation of British currency to the gold currencies of the world is so necessary for the prosperity of British trade that any temporary disadvantage, if such arise, from the measures necessary to maintain parity will be many times outweighed."

In response to sneers from the opposition benches that the gold standard would "shackle" British prices to America's gold dollar, Churchill shot back, "I will tell you what it will shackle us to. It will shackle us to reality."

The reality of a market economy is that prices and wages must be flexible in both directions. They can't stand still as long as tastes, technology and competition are changing. The partisans of inflation, then and now, oppose falling prices. I am going to say that the natural tendency of prices in a productive market economy is downward. They fall as the techniques of production improve. One might—I would—call this "progress." Today's central bankers rather call it "deflation." Inflationphilia and deflation-phobia are two sides of the same intellectual coin.

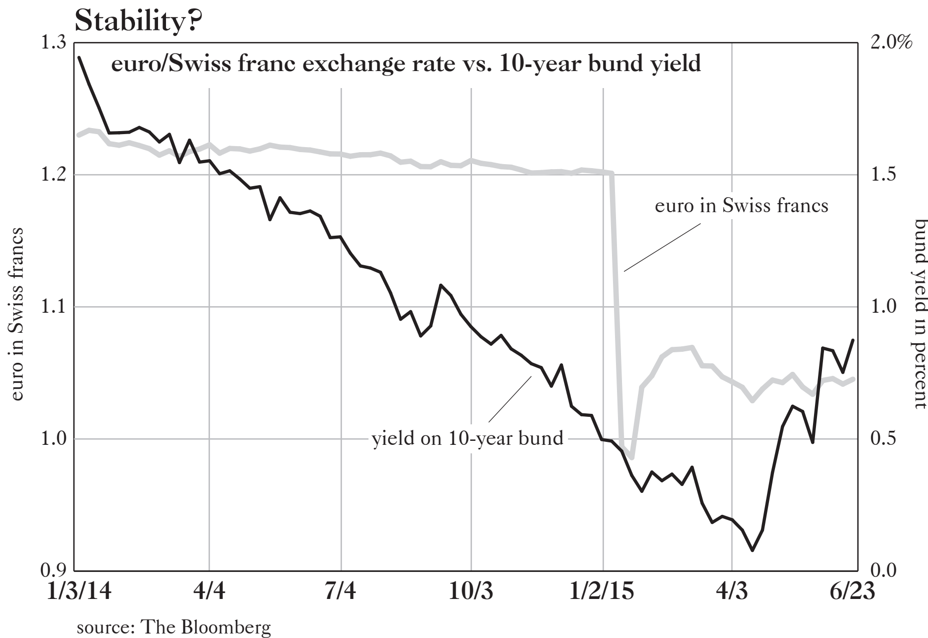
Still, when a price becomes distorted, something has to give. What might that something be? Nowadays, we lay the burden of adjustment on interest rates and exchange rates—on the value of money, or the cost of money, rather than on an underlying distortion in the marketplace. Better that interest rates should fall than, just for example, house prices should fall. Better QE and ZIRP than the sudden, full consequences of the preceding levitation in residential real estate. So holds the consensus of Keynesian political opinion.

There was a constituency for these ideas even before Keynes made them popular. "I have sense enough to realize that it may be in the interests of the country to go back to the gold standard," John Baker, a Laborite son of a bricklayer, said in parliamentary debate, "but don't tell me it is in the interests of the men who will be thrown out of work."

Baker had nothing against the gold standard per se—the problem lay in the exchange rate. Neither did Philip Snowden, a former chancellor under the Labor Prime Minister Ramsay MacDonald, object to the gold standard in principle. He protested against the precipitous rush to restore it. To judge by the tone of discussion, the gold pound commanded widespread support. Keynes himself would sometimes lightly tip his hat to it.

He tipped it more energetically to the emerging idea of managed currencies. His "Economic Consequences of Mr. Churchill" belittled the price mechanism and deployed the rhetoric of social justice in contending against wage reductions. It scorned "conventional finance" and "so-called sound policy," thus anticipating—no doubt helping to bring to fruition—the generations' long redefinition of the term "sound." To Keynes, the free market was a machine, a "Juggernaut." Heartless and headless, it needed helping hands—his, for instance.

"The gold standard," he wrote, "with its dependence on pure chance, its faith in 'automatic adjustments,' and its general regardlessness of social detail, is an essential emblem and idol of those who sit in the top tier of the machine." Britain was running an unwise risk "if we continue to apply the principles of an Economics which was worked out on the hypotheses of laissez-faire and free competition in a society which is rapidly abandoning these hypotheses." In other words, the price mechanism would certainly fail to function if it were not allowed



to function—you could hardly argue with *that* Keynesian doctrine.

Keynes was in touch with his times, certainly. Even the self-described proponents of the gold standard turned away from the classical prewar edition of that elegant monetary system. They wanted the respectability without the rigor (putting aside, for a moment, the all-important matter of the exchange rate). What they rather embraced was the gimmicky gold exchange standard. It was a yardstick made of rubber.

A Bloomsbury wit had said that a proper cake was one that you could have *and* eat. Here was the essence of the gold exchange standard—in fact, it remains today, the essence of our non-standard, what we at *Grant's* call the Ph.D. standard after the one-time tenured economics faculty who guide our monetary destiny. Before 1914, gold-standard countries settled their international accounts in gold or in currencies immediately convertible into gold. Under the gold exchange standard, sterling (and dollars, too) did double duty as official reserves. They themselves became a kind of paper gold. Britain could—and did—allow sterling liabilities to pile up offshore, secure in the (errant) conviction that its creditors would never demand bullion in exchange for its proliferating pounds.

The broad effect of the gold exchange standard "will be not only to allow for an unlimited credit expansion without inflation but also to aim at price stabilization and, incidentally, at wage stabilization. . . ." So Robert Boothby, a Tory MP, promised the House of Commons in 1925. "What I want to emphasize," Boothby went on, "is that we have really passed beyond the stage where one can recommend that there should be no control of economic forces, and that is why I hope we are not going back to a purely automatic gold standard."

"Unlimited credit expansion without inflation"—does that not have a modern ring to it? Unfortunately for our 21st century prospects, the Boothby-warranted monetary system collapsed in a heap in 1931. When push came to shove, Britain's creditors did demand gold, which the Bank of England declined to remit.

If our financial descendants are as busy as we are, they will likely lump the manifold errors of the post-crisis period under the broad heading of offenses against common sense. They will be thunderstruck by the things we believe.

I have in mind one particular example of gullibility. We give every sign—I mean, we collectively—of accepting the notion that price control is a viable idea. You may be surprised, as price control is demonstrably non-viable. It has never worked, and no major central bank explicitly sails under its colors. Still, by fixing some interest rates, obliterating others, and nudging still others, the monetary thimble riggers have instituted an effective regime of financial price control. Interest rates are prices, after all.

The abuse of the price mechanism is the principal narrative thread of 21st-century central banking. The authorities profess to believe that they can micro-manage the "price level." I doubt that the price level can be accurately computed, let alone managed to within a few dozen basis points of the central bankers' chosen target. As to the calculation, I refer you to Oskar Morgenstern's critique of the pretenses of statistical precision, "On the Accuracy of Economic Observations," a book more than half a century young. Without knowing, I somehow know that Mario Draghi was not thinking of the skeptical Morgenstern when, last summer at Jackson Hole, Wyo., he invoked the message of the "five-year, five-year" forward inflation rate—meaning the inflation rate projected by futures markets for the half decade beginning in five years' time—as a pretext to implement QE. Mind you, Draghi was drawing inferences about the rate of inflation beginning in the year 2019. Believing that, what could the president of the European Central Bank not believe?

The Federal Reserve's self-selected mission is to cause the price level, as defined, to rise by five-fold over the course of a healthy lifetime. This is the honest meaning of a 2% inflation target. Oddly, the central bankers call it "price stability."

It appears that Churchill did, indeed, underestimate the overvaluation of the pound in 1925. Still, in arguing for what turned out to be the wrong policy, the then chancellor of the exchequer said something that our data-driven Federal Reserve would be well advised to ponder: "Those who found clear-cut mathematical calculations on these index figures are likely to strain the figures further than they are warranted and to draw the wrong conclusions."

The failure of the half-baked gold exchange standard discredited the true-blue gold standard. The failure of the successor, the post-World War II monetary system known as Bretton Woods, discredited the very idea that currency values should be fixed

or anchored. Britain's 1992 departure from the European Exchange Rate Mechanism was another nail in the coffin of fixedness.

Today, we stand at the gates of Keynes's and Boothby's monetary heaven. Exchange rates bob, weave and lurch—in a few minutes of frenzied trading on January 15, the Swiss franc leapt by 41% against the euro. Just in the past few weeks, German bund yields climbed by 1% from not many basis points above zero. The move wiped out more than a dozen years of coupon income. The fact is that today's central bankers, in league with yield-starved investors, have engineered a comprehensive mispricing of credit not seven years after the previous such episode of mispricing. Bloomberg, the other day, quoted analysts from Bank of America as saying that, "We believe we are seeing the slow unraveling of the fixed income markets."

Here in Adam Smith's hometown, I have presumed a little on your affinity for the invisible hand. If you are not so keen as I on price discovery and the free market, I hope at least that you will give some thought to the risks inherent in price administration in a controlled market.

Finally, I hope that we can change our ways before posterity can shake its head at the memory of our mistakes.

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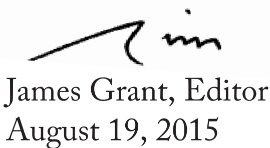

James Grant, Editor
August 19, 2015

GRANT'S
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Vol. 33 Summer Break — Two Wall Street, New York, New York 10005 • www.grantspub.com — AUGUST 19, 2014

Not such a lock

(February 6, 2015) A wave of identity theft and computer-borne financial fraud has hoisted LifeLock—LOCK on the New York Stock Exchange—into the elite ranks of American growth stocks. "Elite" is no part of the LifeLock corporate story, *Grant's* is about to contend. On the company whose CEO famously paraded his own Social Security number in front of the TV cameras just to dare bad actors to steal it (which the taunted thieves actually proceeded to do), this publication is bearish.

Anxiety is LifeLock's stock in trade. If North Korea (let us say) can hack Sony Pictures Entertainment, and if JP Morgan Chase, Home Depot and Target are likewise vulnerable to digital intruders, which ordinary citizen is safe? Some 3.5 million Americans, deciding that they, at least, are unsafe, have signed on. In the 12 months through Sept. 30, LifeLock's revenues jumped by 30% from the year- earlier period. From 2007 through 2013, compound annual growth in the LifeLock top line amounted to no less than 64%; results for the final quarter and full-year 2014 are due on Feb. 10.

Between five and 15 million Americans are annually hacked, according to estimates by Forrester Research and the Department of Justice. "Let's assume," Richard Davis Jr., analyst with Canaccord Genuity, muses with colleague Evan Lorenz, "the only people who have any interest in this product is someone who actually had their identity hacked. So, that's seven million people per year. With LifeLock's churn, which is about 18%, they have to land about 1.2 million of that seven million, so they have to get 17% of those people in that narrowly defined universe of people who had their identities hacked. If that's all they won, a 17% win rate is not that bad. It's not like they need 50% to 60%."

The argument appears to have carried the day with all but one of the nine analysts who follow the company. The shares are valued at 28.9 times trailing net income and 22.7 times the 2015 estimate. Cash per share works out to $2.55; the balance sheet is debt-free. Not since going public in October 2012 has management produced a disappointing quarter. Boldface names—Goldman Sachs, Bessemer Venture Partners, Kleiner Perkins Caufield & Byers—furnished venture capital. Tom Ridge, former head of the Department of Homeland Security, sits on the board of directors.

What, exactly, does LifeLock deliver? Less than the "comprehensive identity theft protection" that it claims. The standard LifeLock protection plan, which sells for $9.99 a month, buys you notification if a credit card account (or mortgage or mobile phone application) is opened in your name. It promises assistance in canceling lost or stolen credit cards. It guards against attempts to tamper with your address. It scans Web sites for signs that someone is filching your vital data, and it blocks pre-approved credit card offers and offers a $1 million service guarantee in case of fraud. For the customer who wants to know if a registered sex offender has moved into his neighborhood or who demands instant notification of major corporate data breaches, higher and costlier levels of service are available. Except for a small enterprise division that verifies customer bona fides for corporate clients, consumer protection is LifeLock's beating heart.

You might suppose that the anti-identity theft industry is thriving. In fact, annual average top-line growth over the past five years amounted to just 0.5%, according to Sarah Kahn, analyst at IBISWorld. Revenue at the only other public company focused on identity-theft protection—Intersections Inc. (INTX on the Nasdaq)—slipped to $262 million in the 12 months ended Sept. 30, 2014, from $373 million in calendar 2011. Intersections markets through banks, where it has collided with the Consumer Financial Protection Bureau. LifeLock has had no such difficulty issuing ads to the hack-wary public.

Many a business in the Internet age has foundered in failing to compete with services that someone, somewhere can deliver for free. Perhaps such a fateful encounter awaits LifeLock. "Consumers can request their credit reports once

"Fiat, boys! I found fiat!"

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