

# “MR. MARKET FLUNKS THE MARSHMALLOW TEST”

GRANT'S SPRING 2017  
CONFERENCE –  
MARCH 15, 2017

# Dante's circles of hell, circa 2017...

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- Limbo
- Lust
- Gluttony
- Greed
- Anger
- Heresy
- Violence
- Fraud
- Treachery
- Short selling

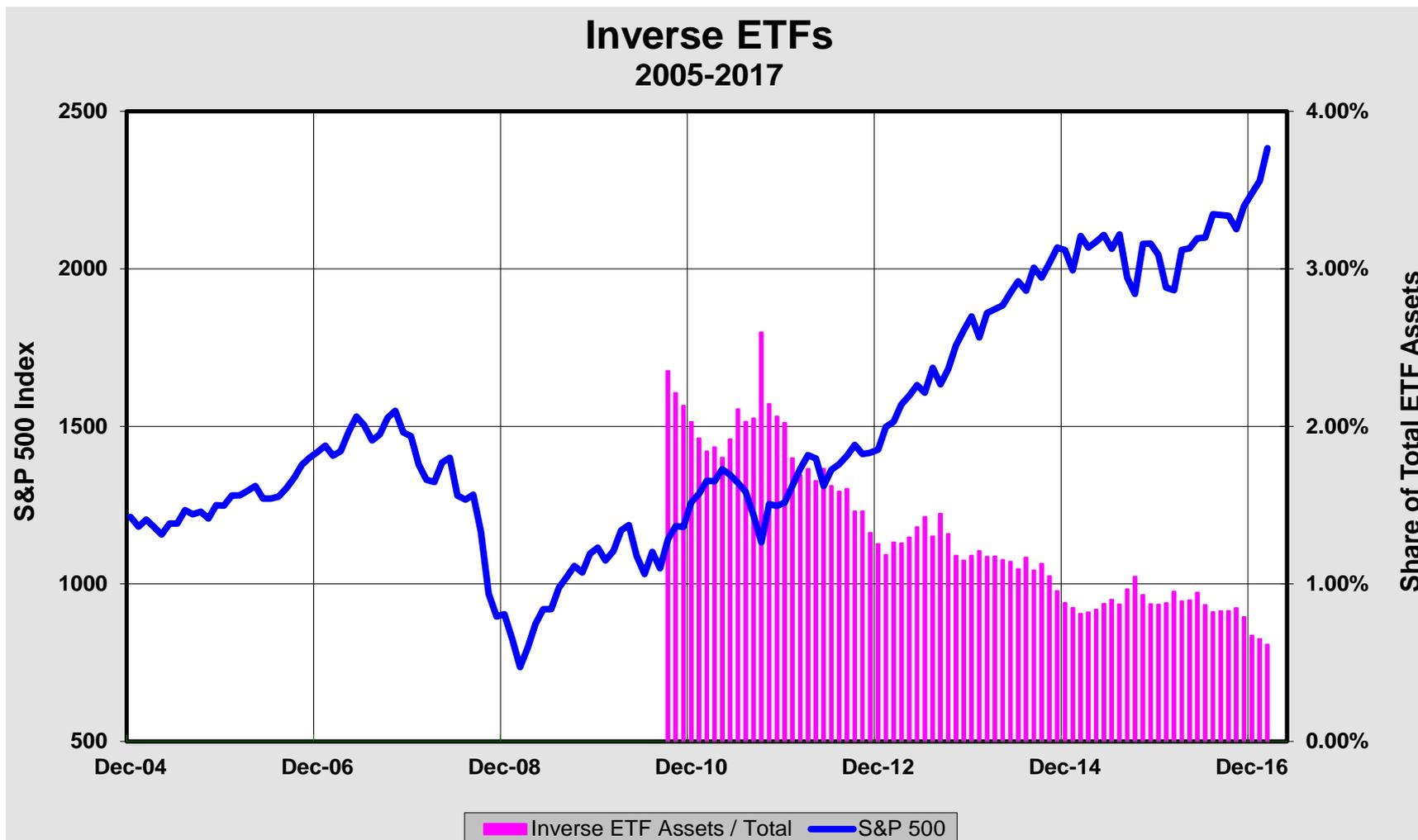


“Let me get this straight – you want to short Janet Yellen *and* Donald Trump?”

# Bear case:

## Near extinction of bear funds

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# Three bubbles in 20 years

## Magnitude and duration

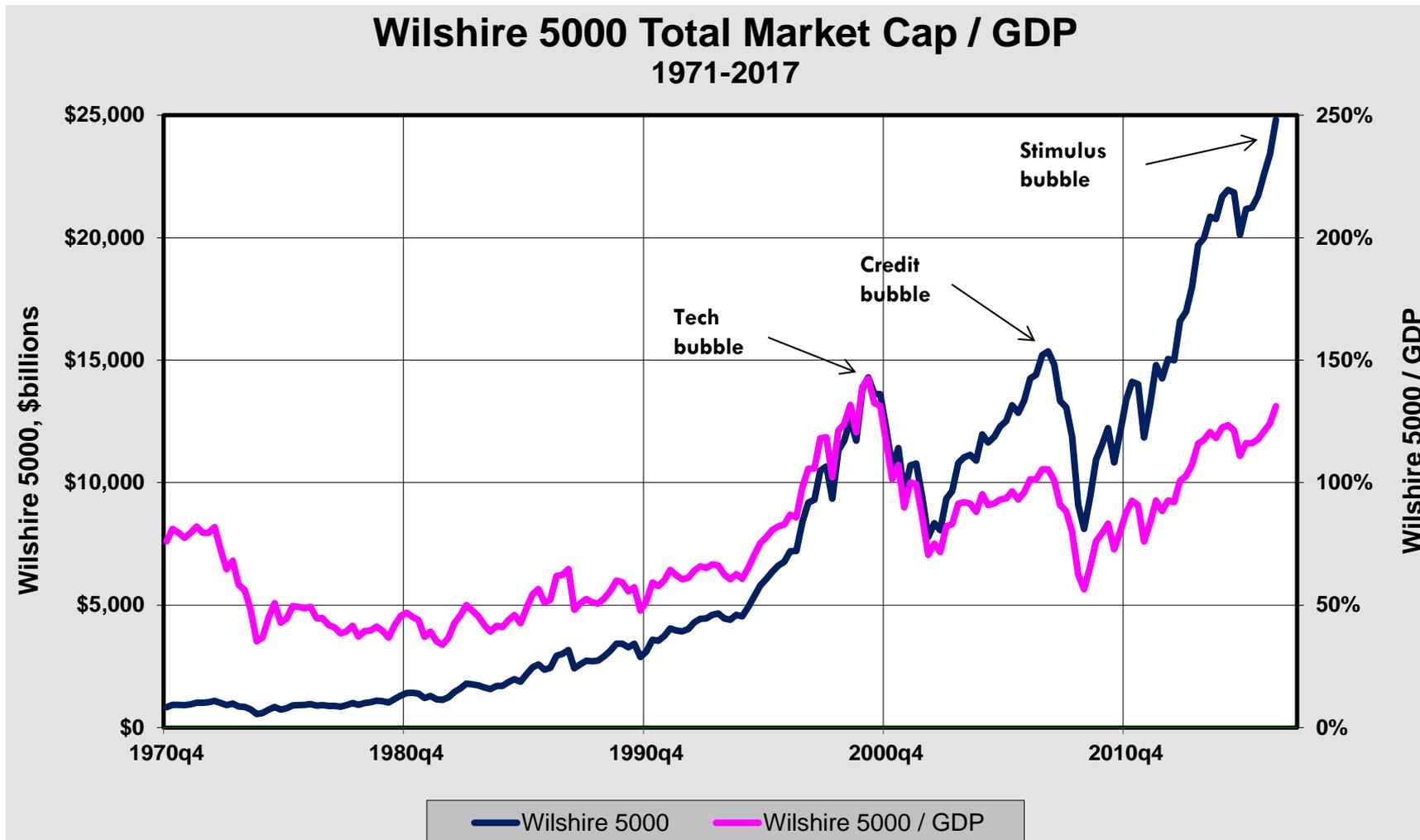
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Start Date	Top Date	Description	S&P 500 Gain	Duration
12/8/94	9/1/00	Technology bubble	+241%	5.74 years
3/11/03	10/9/07	Housing & credit bubble	+95%	4.61 years
3/9/09	3/1/17?	Stimulus & sovereign debt bubble	+255%	7.98 years
		Average of 11 bull markets since WWII	+145%	4.70 years

# Bear case:

## High valuations

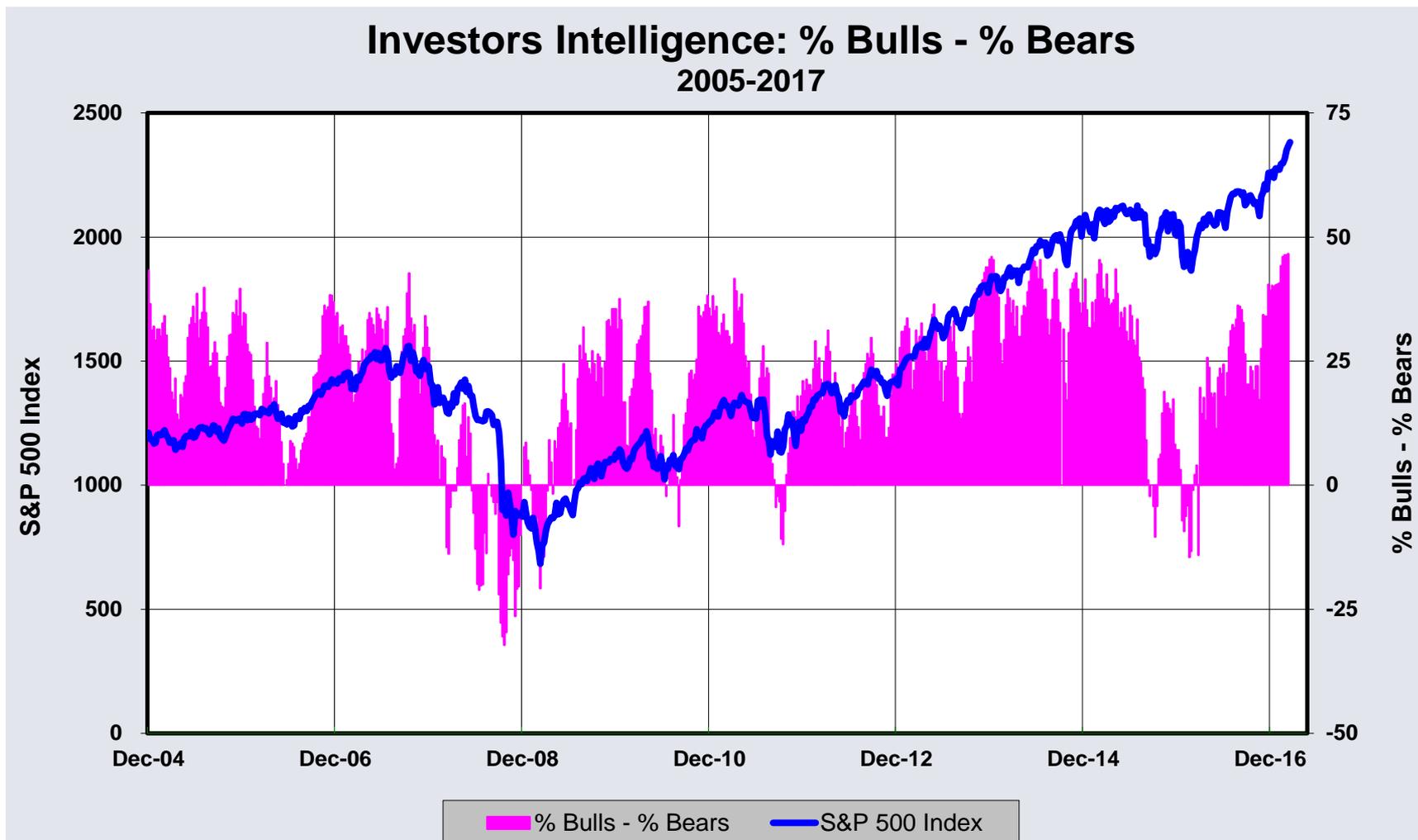
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# Bear case:

## Extreme bullish sentiment

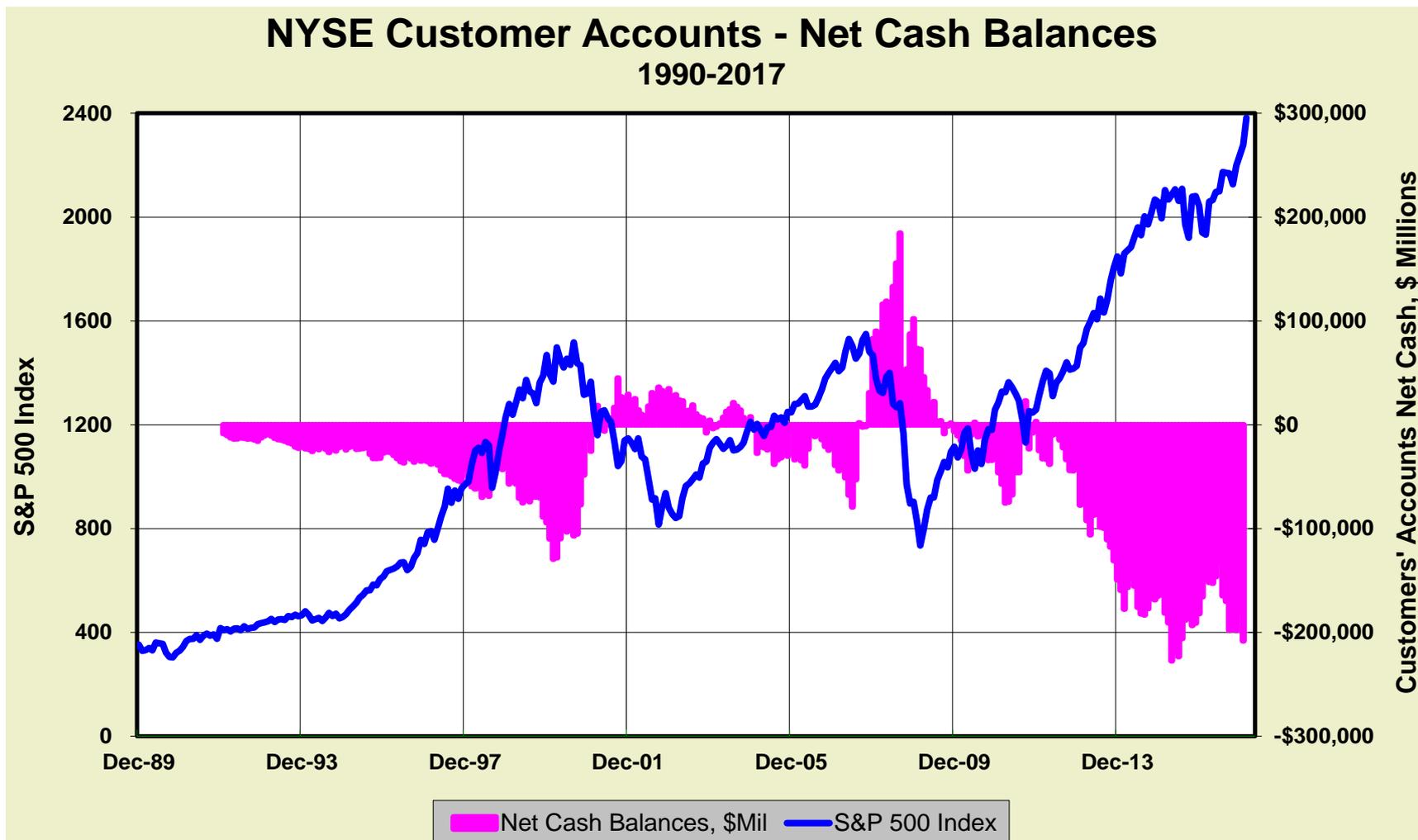
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# Bear case:

## Extreme leverage

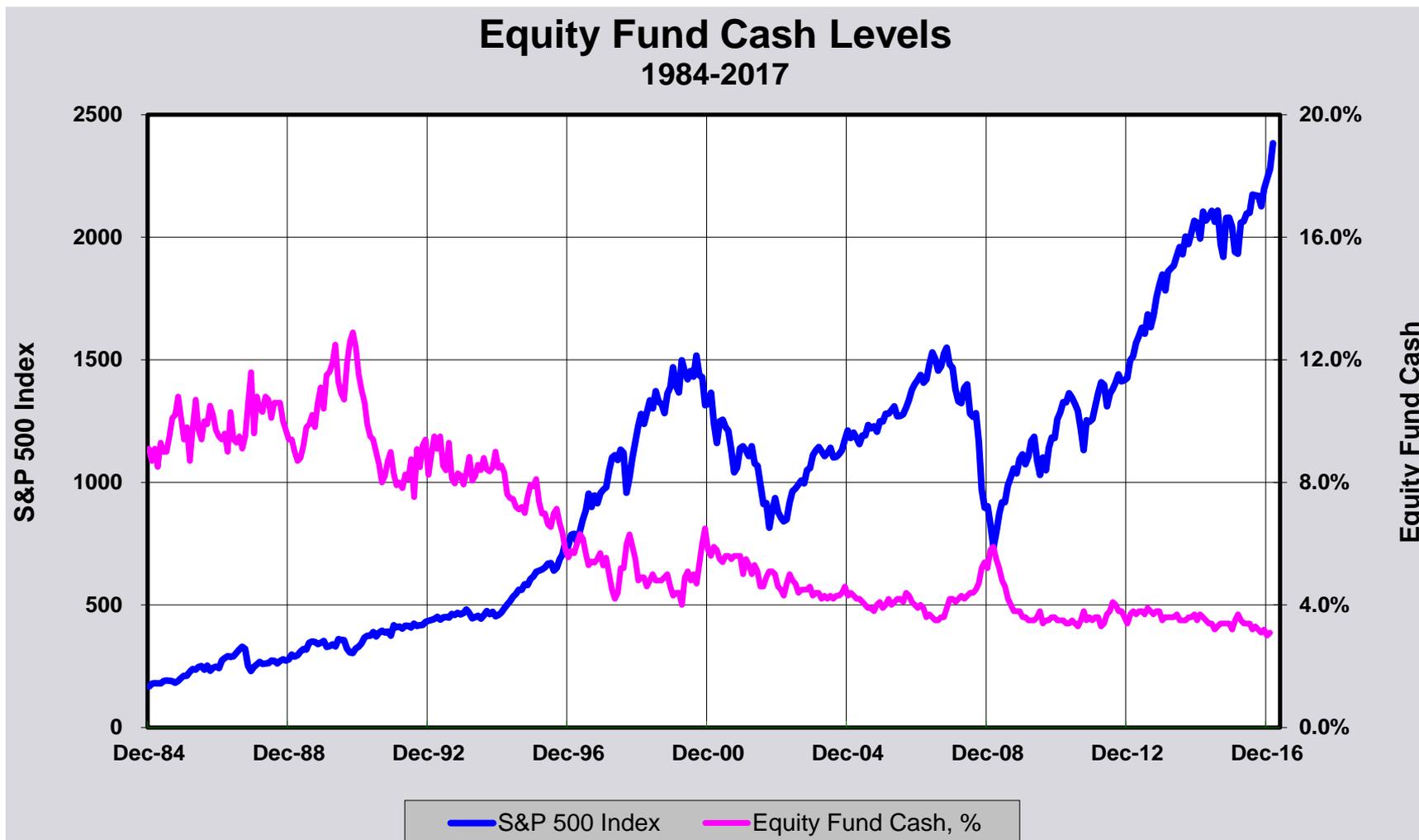
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# Bear case:

## Low cash levels

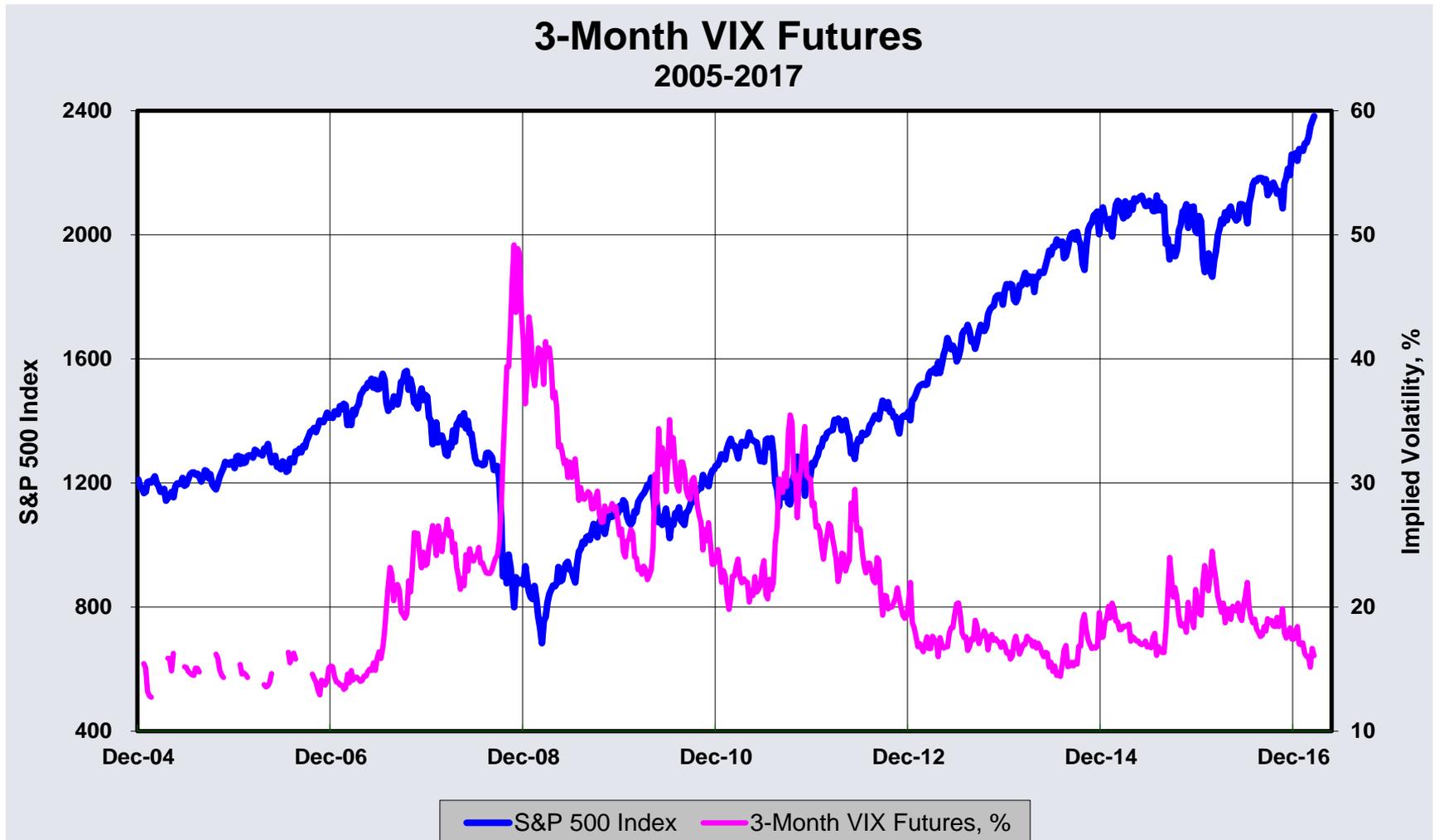
8



# Bear case:

## Low price of portfolio insurance

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Bull case:

Low interest rates cure all

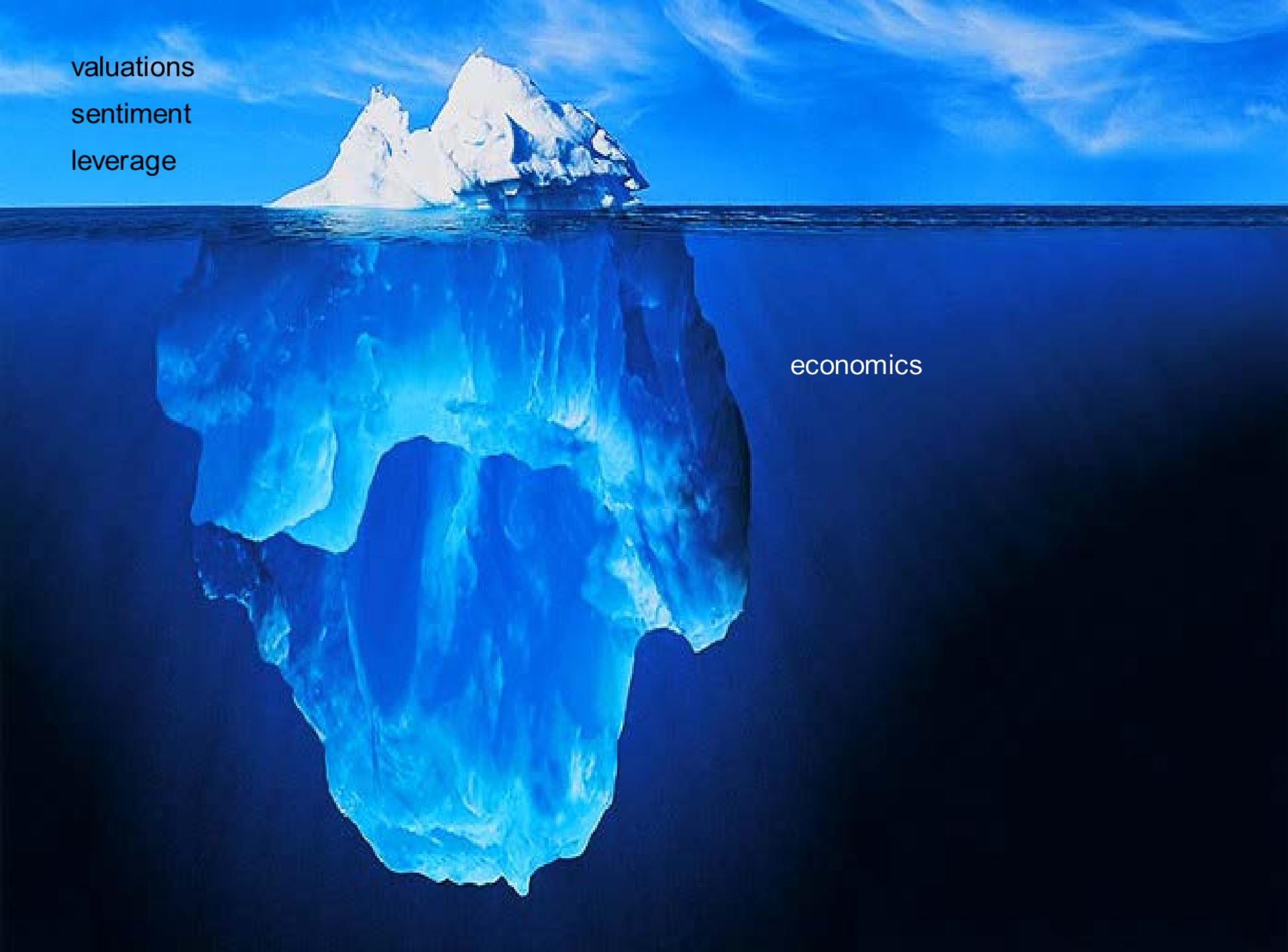


“We are not in bubble territory or anything of that sort... Measured against interest rates, stocks actually are on the cheap side compared with historic valuations. But the risk always is interest rates go up, and that brings stocks down.”

~ Warren Buffett, CNBC interview,  
February 27, 2017

valuations  
sentiment  
leverage

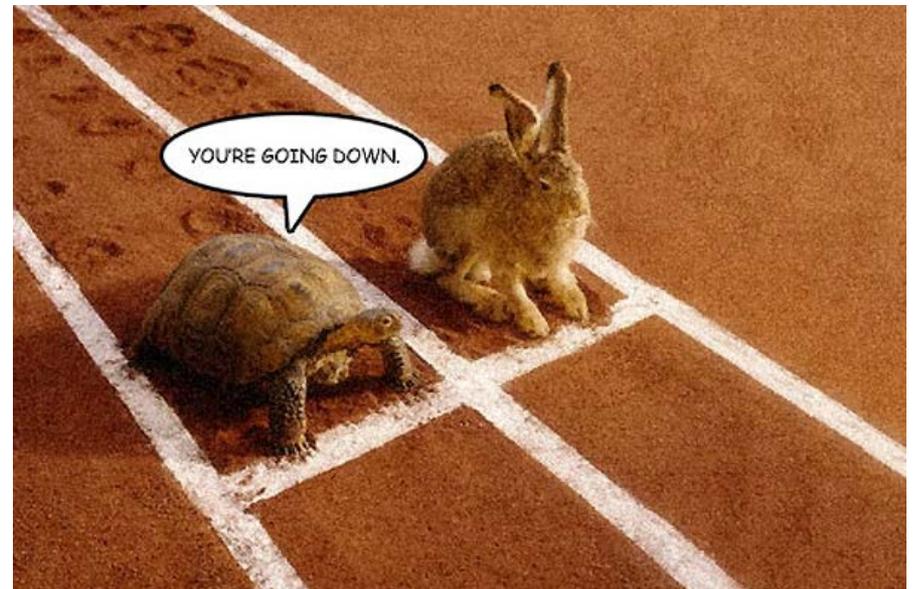
economics



# Keys to economic prosperity

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- ✓ Economic freedom
- ✓ Respect for private property
- ✓ Expanding division of labor
- ✓ **Delayed gratification**



# Oh, The Temptation

## THE MARSHMALLOW TEST

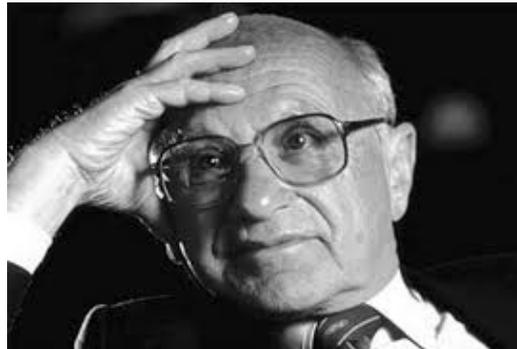


# Print, print, print

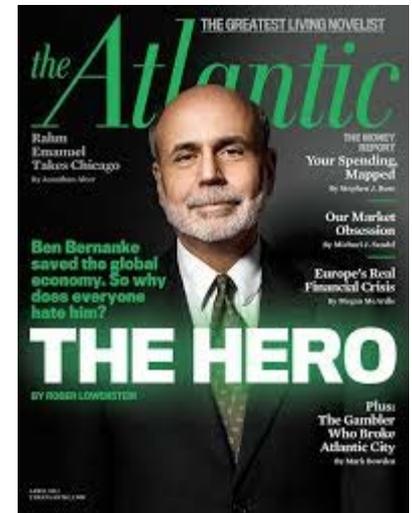
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Irving Fisher



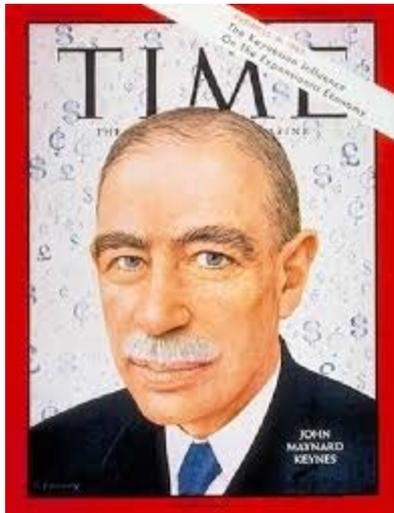
Milton Friedman



Ben Bernanke

# Spend, spend, spend

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John Maynard Keynes



Paul Krugman



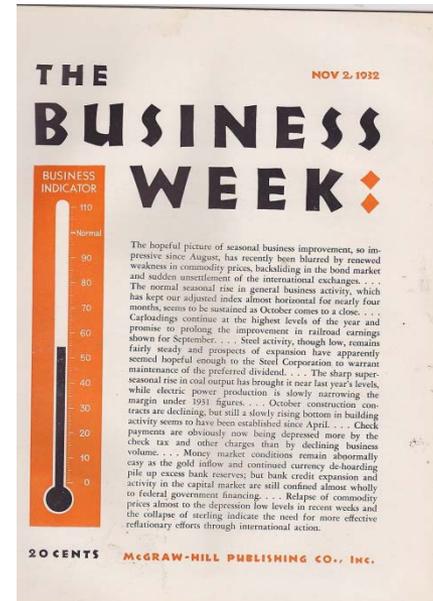
# Print and spend...

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“It may be well again to stress the all-important point that the Federal Reserve has it in its power to change interest rates downward any time it sees fit to do so and thus to stimulate business.”

~ *Financial World*, April 10, 1929



“Just as we saved our way into depression, we must squander our way out of it.”

~ Virgil Jordon, *Business Week* economist, 1932

# Monetary stabilizers fail to learn from history

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Ben Bernanke  
November 8, 2002

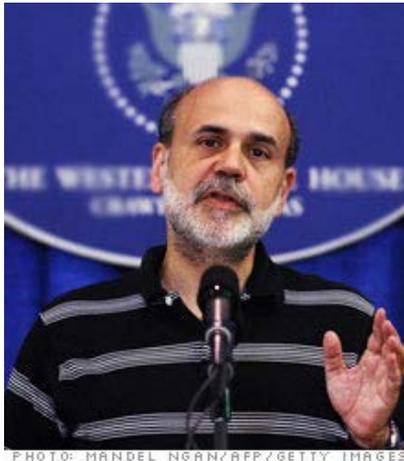


PHOTO: MANDEL NGREN/AFP/GETTY IMAGES

“I would like to say to Milton [Friedman] and Anna [Schwartz]: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again.”

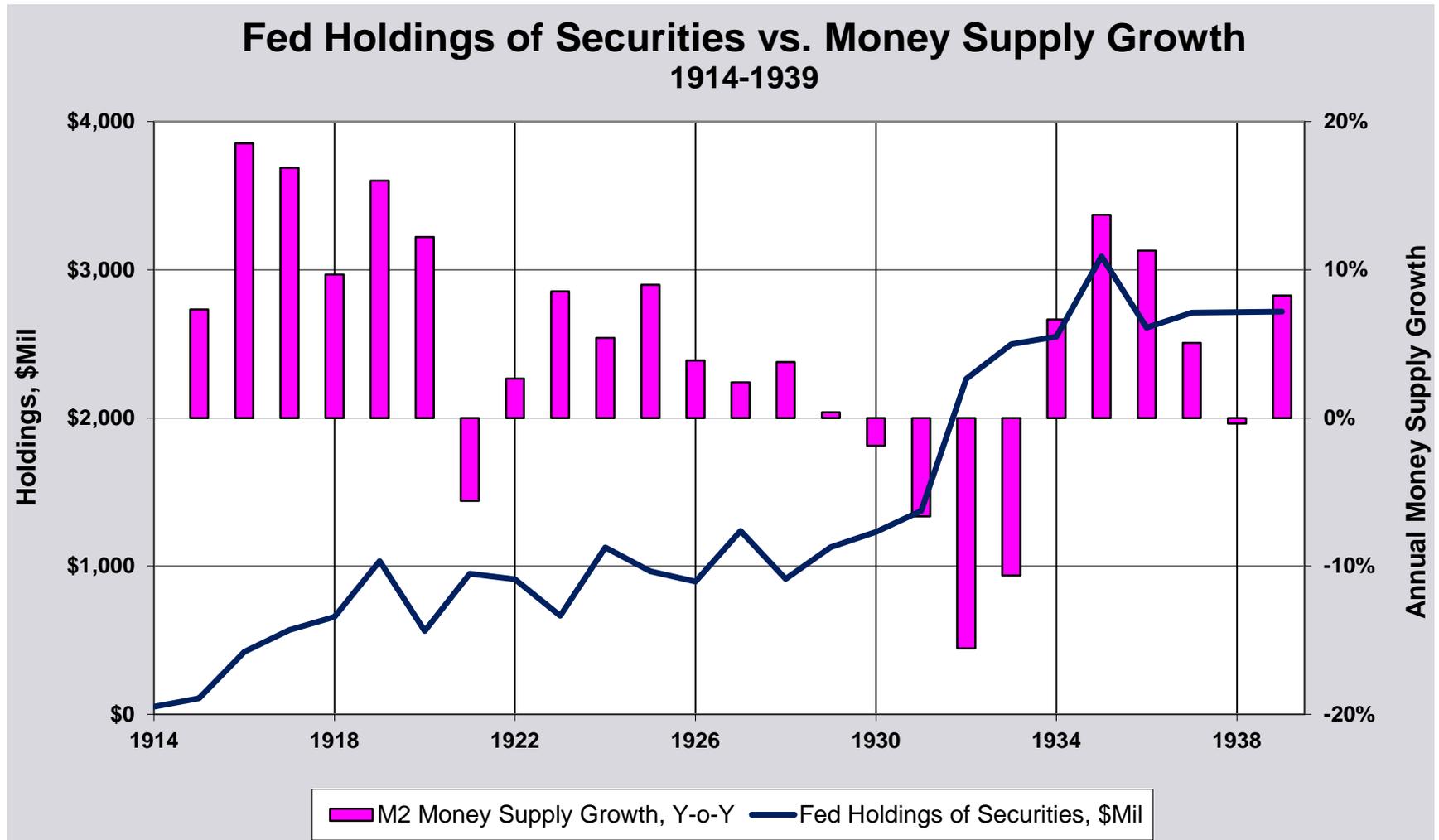
Timothy Geithner  
January 27, 2010



“To stand back and let it burn is irresponsible. It's what happened in the Great Depression.”

# Did the early 1930s Fed really fiddle while Rome burned?

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## The trouble with monetary stimulus

“We must not forget that, for the last six or eight years monetary policy all over the world has followed the advice of the stabilizers. It is high time that their influence, which has already done harm enough, should be overthrown.”

~ Friedrich Hayek, 1932



## Influence of Milton Friedman comes full circle



Professor Bernanke of Princeton was a leading scholar of the Great Depression. He knew how the passive Fed of the 1930s helped create the calamity — through its stubborn refusal to expand the money supply and its tragic lack of imagination and experimentation. Chairman Bernanke of Washington was determined not to be the Fed chairman who presided over Depression 2.0. So when turbulence in U.S. housing markets metastasized into the worst global financial crisis in more than 75 years, he conjured up trillions of new dollars and blasted them into the economy... He didn't just reshape U.S. monetary policy; he led an effort to save the world economy.

~ *Time*, December 29, 2009

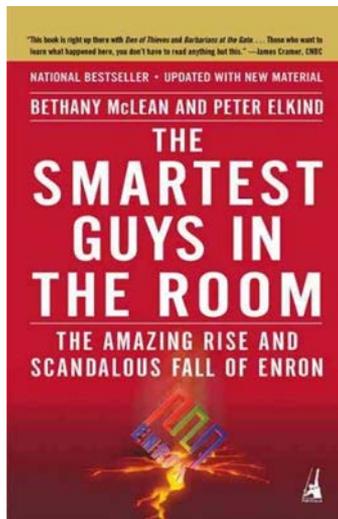
# S&P 500 Edges Higher After Trump Renews Jobs Pledge

By Chuck Mikolajczak | Published February 23, 2017 | Markets | Reuters

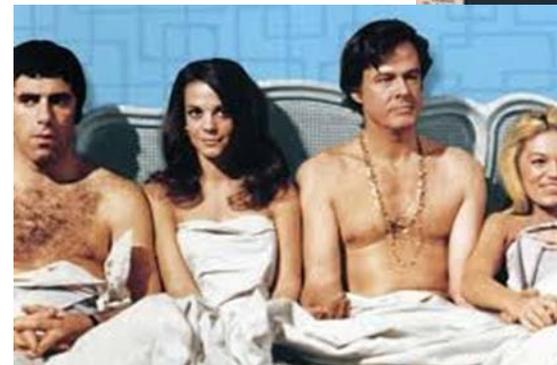


politics

## Instant gratification



financial engineering



sexual revolution

# Dichotomy in time preferences: 2005-2007 credit bubble

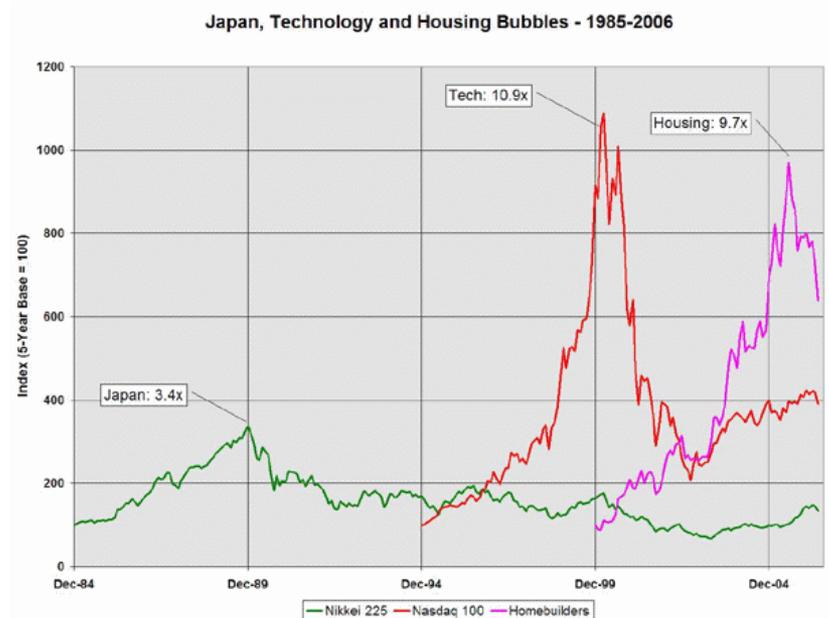
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A long-time friend... points out a distinction in the behavior of the debtor class. Some have clearly acted responsibly: they consolidated their debts into tax deductible mortgages, locked in the lowest long-term rates in 40 years, and tossed the interest savings into their rainy day and investment jars. From a consumption standpoint, little has changed except that these old-school borrowers pocketed a windfall compliments of their friendly neighborhood central banker. Others — to put it mildly — have gotten carried away.

~ Kevin Duffy

“Are Mortgage Borrowers Rational?”

June 24, 2006

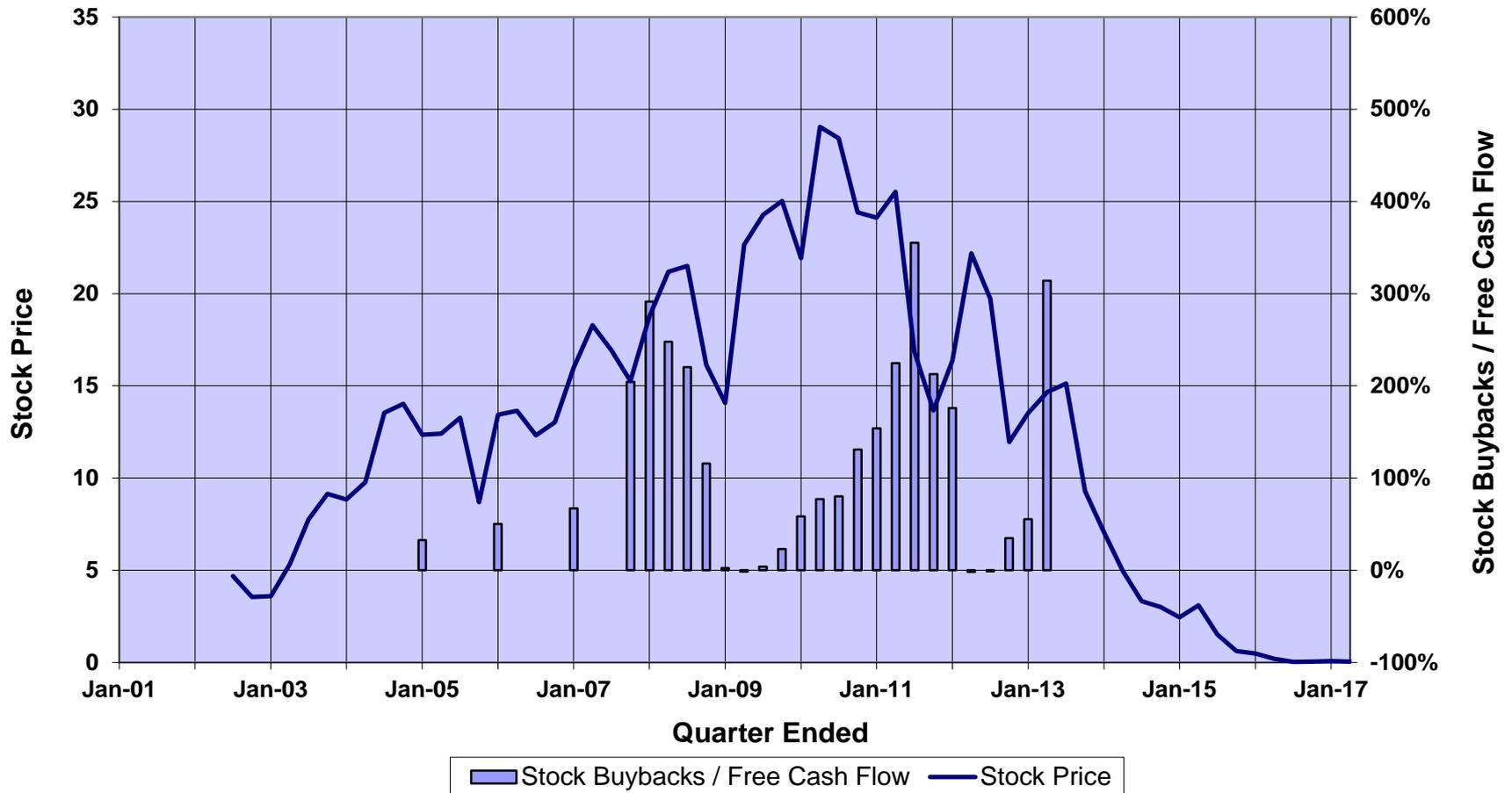


# Instant gratification

## Financial engineering – stock buybacks

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**Aeropostale**  
Annual Buybacks / Free Cash Flow

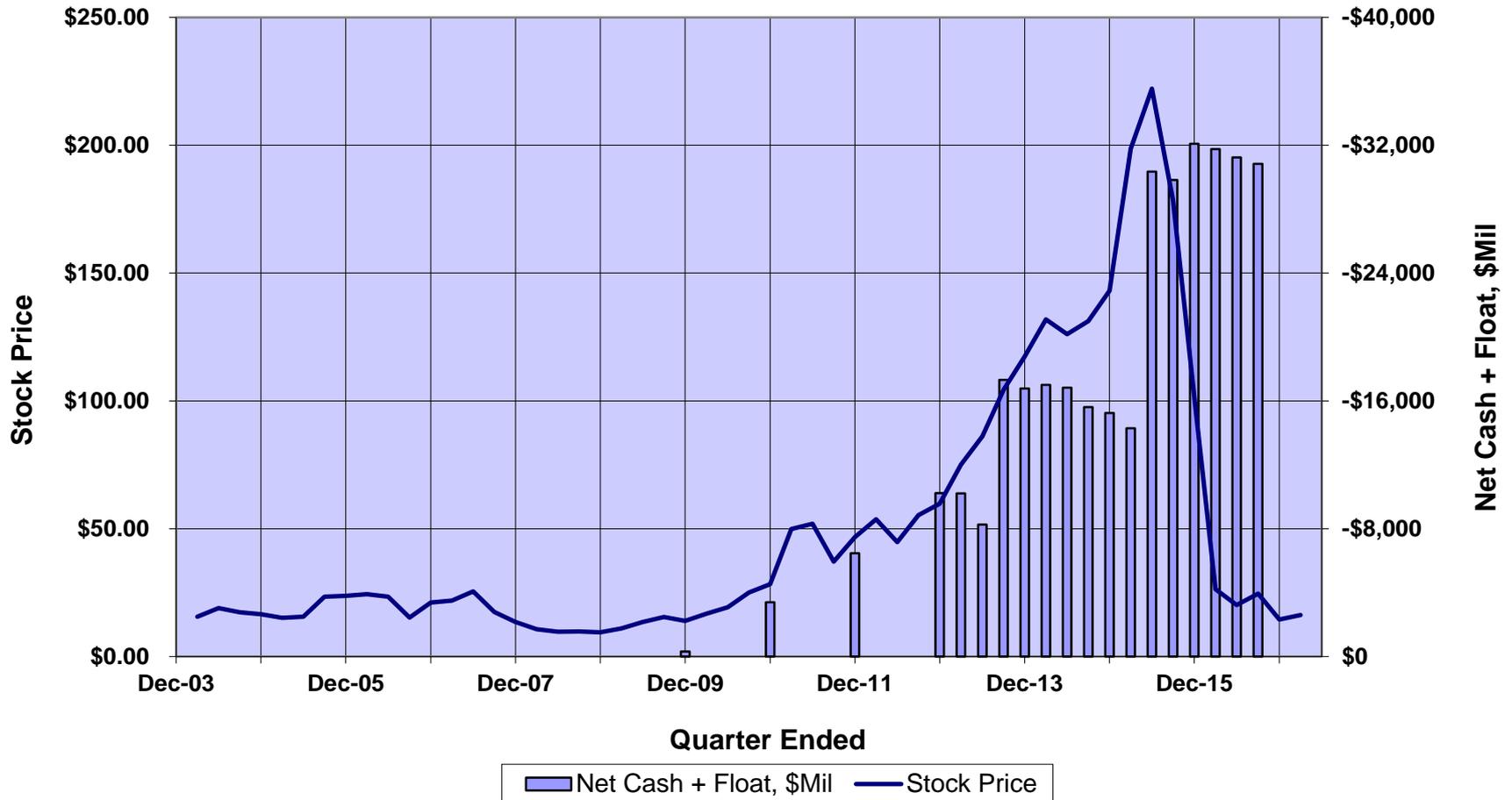


# Instant gratification

## Financial engineering – debt-fueled M&A

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### Valeant Pharmaceuticals Net Cash + Float

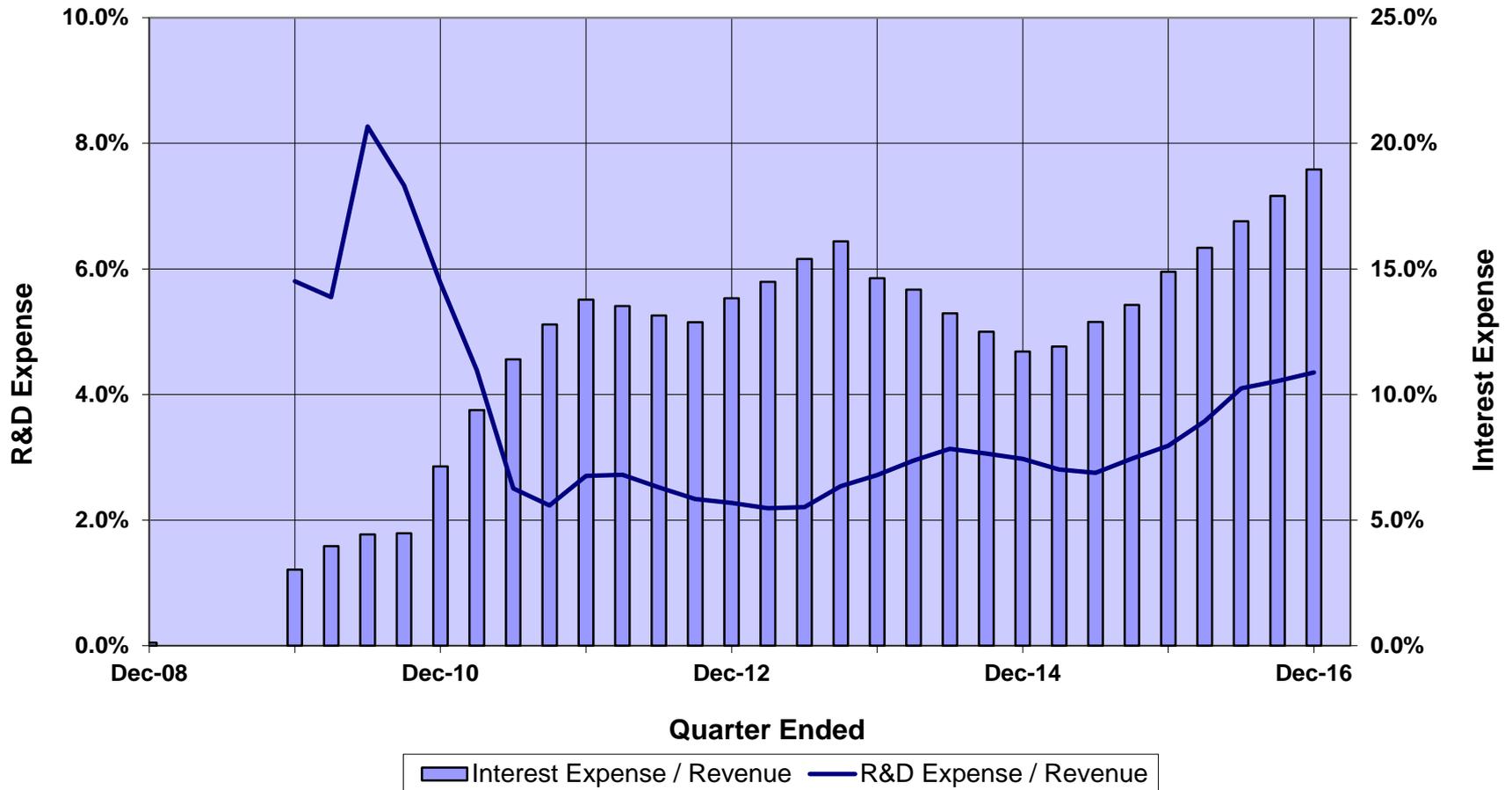


# Instant gratification

## Financial engineering – debt-fueled M&A

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### Valeant Pharmaceuticals R&D Spending vs. Interest Expense



Short selling landmines:  
Delayed gratifiers / disruptors

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**amazon**

**illumina**<sup>®</sup>

**Google**

**NETFLIX**

 **nVIDIA**<sup>®</sup>

**REGENERON**

Short strategy:

Identify grass huts most vulnerable to economic storm



Short themes:

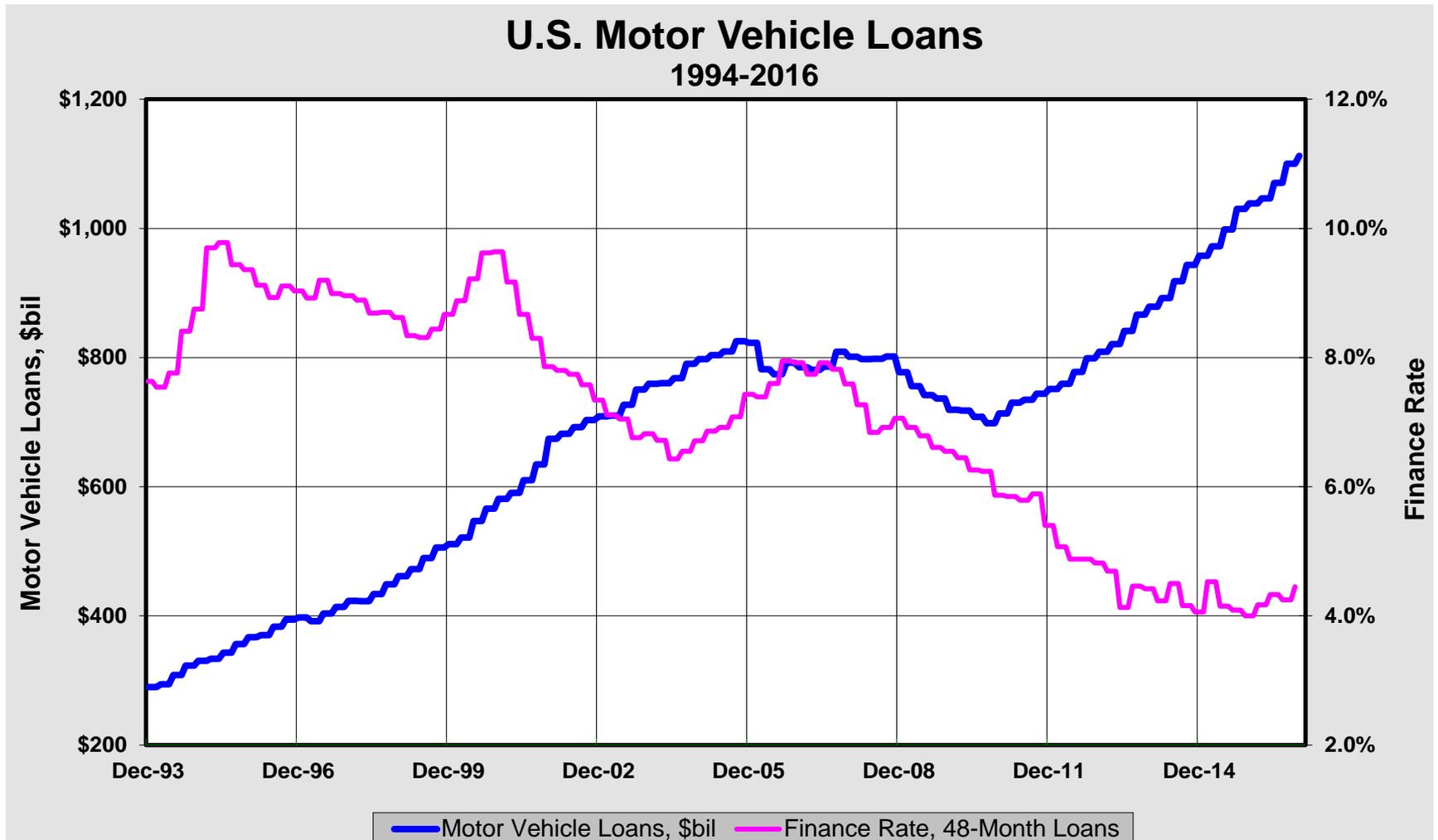
Discretionary consumption + aggressive financing

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# Short themes: Auto finance

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## Short themes:

Time preference dichotomy = opportunity for active investors

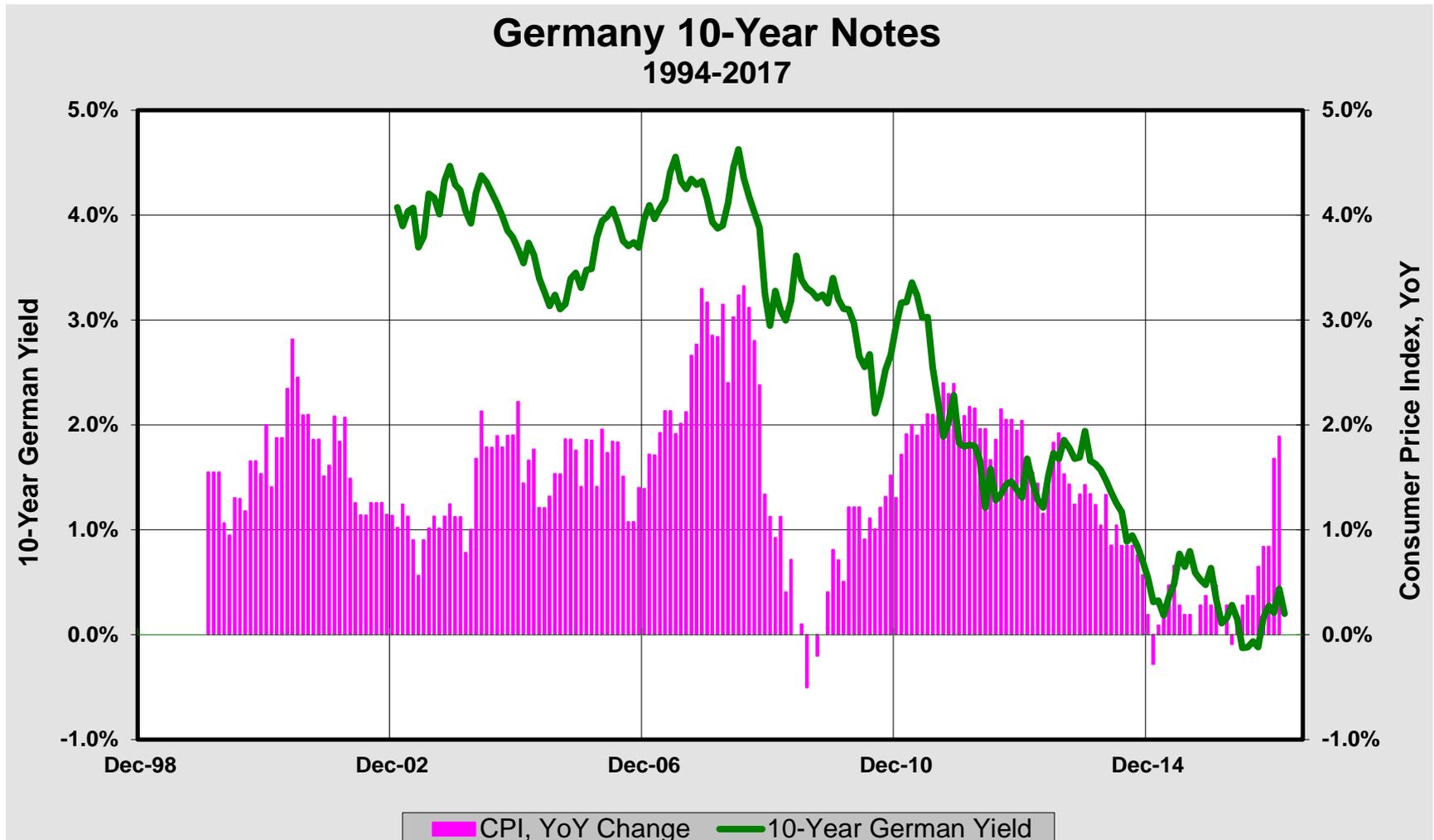
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Company	Symbol	3/3/17 Price	Enterprise Value (\$bil)	Annual Revenue (\$bil)	3/3/17 EV/Revenue
<b>BlackRock</b>	<b>BLK</b>	<b>390.17</b>	<b>\$62.38</b>	<b>\$11.16</b>	<b>5.59</b>
SEI Investments	SEIC	51.32	\$7.47	\$1.40	5.33
Affiliated Managers	AMG	168.75	\$11.13	\$2.19	5.07
T. Rowe Price	TROW	71.31	\$16.08	\$4.22	3.81
Invesco	IVZ	32.33	\$17.31	\$4.73	3.65
GAMCO Investors	GBL	29.54	\$1.05	\$0.35	2.98
Janus Capital	JNS	12.33	\$1.76	\$1.01	1.74
Franklin Resources	BEN	42.68	\$15.19	\$6.42	2.37
Legg Mason	LM	37.06	\$4.63	\$2.78	1.66
<i>Total excl. BLK:</i>			<b>\$74.62</b>	<b>\$23.10</b>	<b>3.23</b>

# Short themes:

## Government spending + reach-for-yield bubble

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# Smart money recommends shorting German bunds at 2017 Barron's Roundtable

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Jeffrey Gundlach



“Some things should be avoided in a major way because they have risk without rewards. One of the greatest trades of the year could be shorting German bunds.”

Felix Zulauf



“I would short 10-year Italian bonds and German bunds in the futures market... Inflation in Germany is at 1.7% and probably will top 2%. The yield on the 10-year is 25 or 30 basis points.”

## On interest rate suppression...



“Credit expansion is the government’s foremost tool in their struggle against the market economy. In their hands it is the magic wand designed to conjure away the scarcity of capital goods, to lower the rate of interest or to **abolish it altogether**, to finance lavish government spending, to expropriate the capitalists, to contrive everlasting booms, and to make everyone prosperous.”

~ Ludwig von Mises, *Human Action* (1949)

# Mises anticipates Bank of Japan

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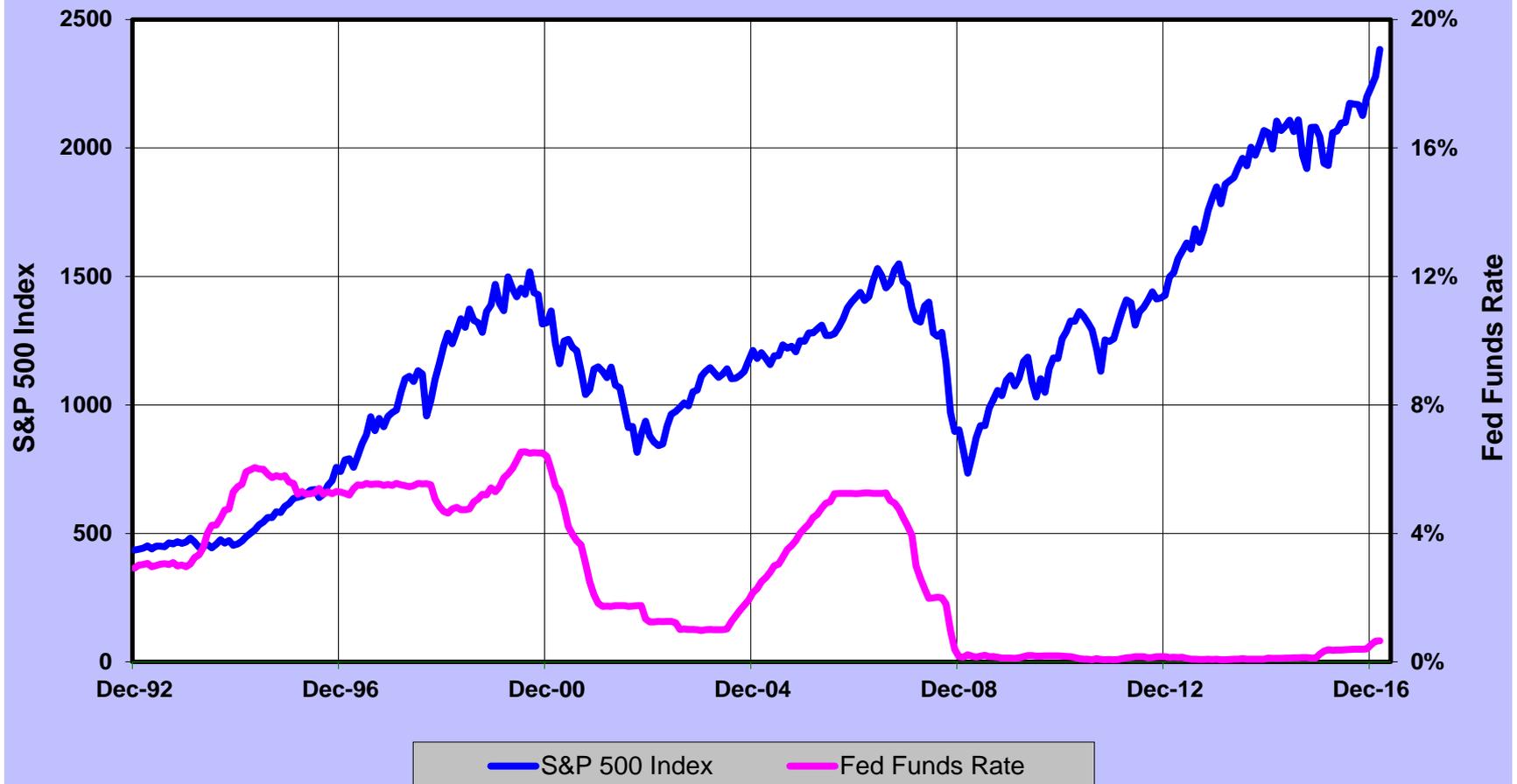
## Bank of Japan Discount Rate vs. Nikkei 225 Index 1985-2014



# Mises anticipates Bernanke/Yellen Fed

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## Fed Funds Rate vs. S&P 500 Index 1993-2017





## Epitaph for consumption-first policies...

“The boom squanders through malinvestment scarce factors of production and reduces the stock available through **overconsumption**; its alleged blessings are paid for by impoverishment.”

~ Ludwig von Mises, *Human Action* (1949)

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