"The New TVA"

War is too important to be left to the generals.
– Georges Clemenceau (1841 – 1929)

Competition has been shown to be useful up to a certain point and no further, but cooperation, which is the thing we must strive for today, begins where competition leaves off. … If we call the method regulation, people will hold up their hands in horror and say 'un-American' or 'dangerous.' But if we call the same process cooperation these same old fogeys will cry out 'well done.'
– Franklin Roosevelt (1882 – 1945)

The New Yorker magazine's cartoons of the plump, terrified Wall Streeter were accurate; business was terrified of the president. But the cartoons did not depict the consequences of that intimidation: that businesses decided to wait Roosevelt out, hold on to their cash, and invest in future years.
– Amity Shlaes, "The Forgotten Man" (2007)

Quite possibly the TVA idea is the greatest single American invention of this century, the biggest contribution the United States has yet made to society in the modern world.
– John Gunther, "Inside USA" (1947)

***Don Draper*:** This is the greatest advertising opportunity since the invention of cereal. We have six identical companies making six identical products. We can say anything we want. How do you make your cigarettes?

***Lee Garner, Jr.*:** I don't know.

***Lee Garner, Sr.*:** Shame on you. We breed insect repellant tobacco seeds, plant them in the North Carolina sunshine, grow it, cut it, cure it, toast it …

***Don Draper*:** There you go. There you go.

[*Writes on chalkboard and underlines: "IT'S TOASTED."*]

***Lee Garner, Jr.*:** But everybody else's tobacco is toasted.

***Don Draper*:** No. Everybody else's tobacco is poisonous. Lucky Strikes … is toasted.

– "Mad Men: Smoke Gets in Your Eyes" (2007)

"How the Children Played at Slaughtering," for example, stays true to its title, seeing a group of children playing at being a butcher and a pig. It ends direly: a boy cuts the throat of his little brother, only to be stabbed in the heart by his enraged mother. Unfortunately, the stabbing meant she left her other child alone in the bath, where he drowned. Unable to be cheered up by the neighbours, she hangs herself; when her husband gets home, "he became so despondent that he died soon thereafter".
– The Guardian, "[Grimm Brothers' Fairytales have Blood and Horror Restored in New Translation](#)" November 12, 2014

The California Public Employees' Retirement System said it missed its return target by a wide margin, hurt by a sluggish global economy and an under-performing private equity portfolio. The nation's largest public pension fund said its investments returned just 2.4% for its fiscal year, ended June 30, far below its 7.5% investment target.
– Los Angeles Times, "CalPERS Misses Its Target Return by a Wide Margin" July 13, 2015

As the world moves slowly towards more economic stability, the outlook for gold is more uncertain than ever.
– Wall Street Journal, "How the Street is Weighing Up Gold's Lost Shine" July 20, 2015

When a market malfunctions, the government should not let market sentiment turn from bad to worse. It should use powerful measures to strengthen market confidence.
– The People's Daily (official China newspaper), July 20, 2015

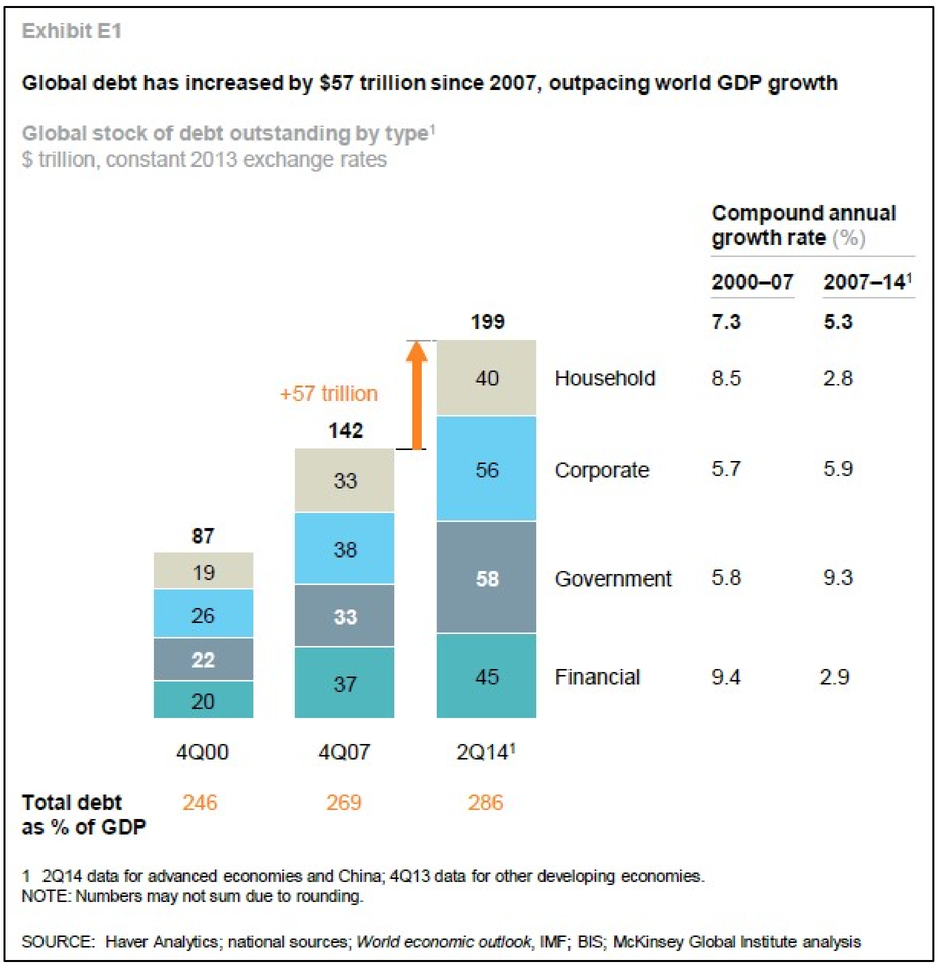
My favorite scene from *Mad Men* is the picnic scene from Season 2. The Draper family enjoys a lovely picnic at some park, and at the conclusion of the meal Don tosses his beer cans into the bushes and Betty just flicks the blanket and leaves all the trash right there on the grass. Shocking, right? I know this is impossible for anyone under the age of 30 to believe, but this is EXACTLY what picnics were like in the 1960's, even if a bit over the top in typical Draper fashion. There was no widespread concept of littering, much less recycling and all the other green concepts that are second nature to my kids. I mean … if I even thought about Draper-level littering at a Hunt picnic today my children would consider it to be an act of rank betrayal and sheer evil. I'd be disowned before they called the police and had me arrested.

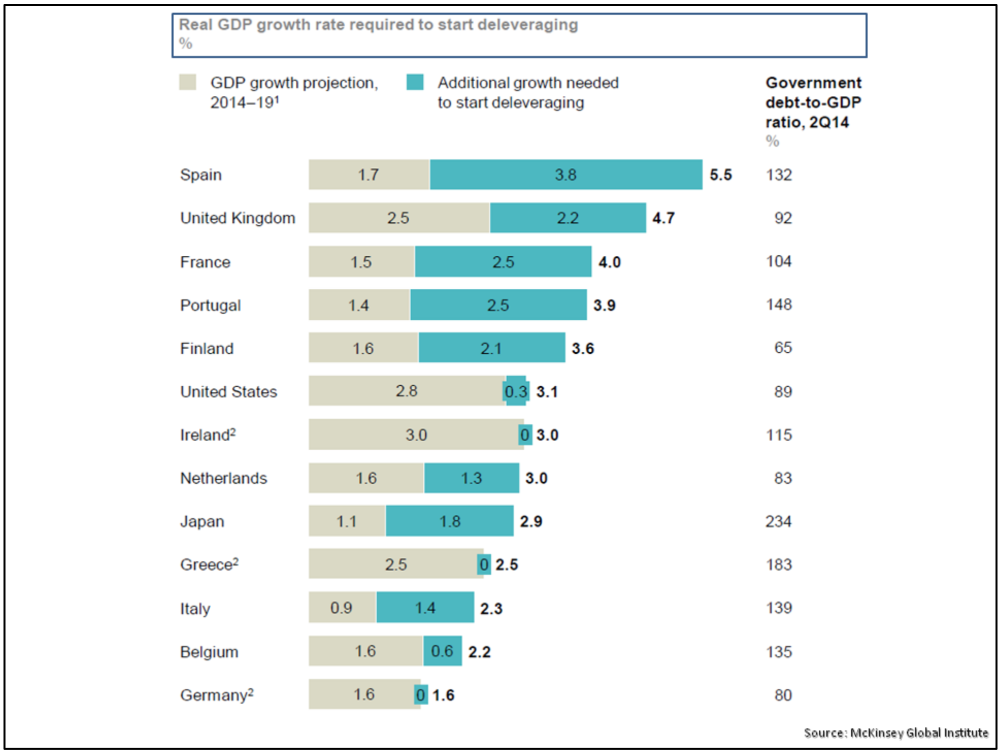
Like many of us who were children in a *Mad Men* world, I can remember the moment when littering became a "thing", with the 1971 public service commercial of an American Indian (actually an Italian actor) shedding a tear at the sight of all the trash blighting his native land. Powerful stuff, and a wonderful example of the way in which Narrative construction can change the fundamental ways our society sees the world, setting in motion behaviors that are as second nature to our children as they were unthinkable to our parents. It's barely noticeable as it's happening, but one day you wake up and it's hard to remember that there was a time when you didn't believe that littering was a crime against humanity.

This dynamic of change in *meaning* is rare, but it takes place more often than you might think. Dueling and smoking are easy examples. Slavery is, too. Myths and legends turned into nursery rhymes and fairy tales is one of my favorite examples, as is compulsory public education … a concept that didn't exist until the Prussian government invented it to generate politically indoctrinated soldiers who could read a training manual. Occasionally – and only when political systems undergo the existential stress of potential collapse – this dynamic of change impacts the meaning of the Market itself, and I think that's exactly what's taking place today. **Through the magic of Narrative construction, capital markets are being transformed into political utilities**.

It's not a unique occurrence. The last time investors lived through this sort of change in what the market *means* was the 1930s, and it's useful to examine that decade's events more closely, in a history-rhyming sort of way. What's less useful, I think, is to spend our time arguing about whether this transformation in market meaning is a good thing or a bad thing. It is what it is, and the last thing I want to be is a modern day version of one of those grumpy old men who railed about how Roosevelt was really the Anti-Christ. What I will say, though (and I promise this will be my last indication of moral tsk-tsking, for this note anyway), is that I have a newfound appreciation for why they were grumpy old men, and I feel keenly a sense of loss for the experience of markets that I suspect my children will never enjoy as I have. I suspect they will never suffer in their experience of markets as I have, either, but there's a loss in that, as well.

It's totally understandable why status quo political interests would seek to transform hurly-burly capital markets into a stable inflation-generation utility, as summed up in the following two McKinsey charts.





Both of these charts can be found in the February 2015 McKinsey paper, "Debt and (not much) deleveraging", well worth your time to peruse. Keep in mind that the data used here is from Q2 2014, back when Greece was still "fixed", the Fed had not proclaimed its tightening bias, and China was still slowing gracefully. All of these numbers are worse today, not better.

So what do the numbers tell us? Two things. **First, there's more debt in the world today than before the Great Recession kicked off in 2008.** All the deleveraging that was supposed to happen … didn't. Sure, it's distributed slightly differently, both by sector and by geography – and that's critically important for the political utility thesis here – but whatever overwhelming debt levels you thought triggered a super-cyclical, structural recession then … well, you've got more of it now. **Second, it's impossible to grow our way out of these debt levels.** Japan, France and Italy would have to more than double their current GDP growth rates (and again, these are last year's more optimistic projections) to even start to grow their way out of debt. Right. Good luck with that. Spain needs a triple. Even the US, the best house in a bad neighborhood, needs >3% growth from here to eternity to start making a dent in its debt. Moreover, every day you don't achieve these growth levels is a day that the debt load gets even larger. These growth targets are a receding target, soon to be well out of reach for every country on Earth.

The intractable problem with these inconvenient facts is that there are only three ways to get out from under a massive debt. You can grow your way out, you can inflate your way out, or you can shrink your way out through austerity and/or assignment of losses. Door #1 is now effectively impossible for most developed economies. Door #3 is unacceptable to any status quo regime. So that leaves Door #2. The ONLY way forward is inflation, so that's what it's going to be. There is no Plan B. What sort of inflation is most amenable to modern political influence? Financial asset inflation, by a wide margin. Inflation in the real economy depends on real investment decisions by real businesses, and just as in the 1930s most business decision makers are sitting this one out, thank you very much. Or just as in the 1930s they're "investing" in stock buy-backs and earnings margin improvement, which doesn't help real world inflation at all. What political institutions are most capable of promoting inflation? Central banks, again by a wide margin. Just as in the 1930s, almost every developed economy in the world has a highly polarized electorate and an equally polarized legislature. The executive may be willing, but the government is weak. Far better to wage the inflation wars from within the non-elected walls of the Eccles Building rather than the White House.

Now … how to wage that inflation war with the proper Narrative armament? No one wants inflation in the sense of "runaway inflation", to use the phrasing of doomsayers everywhere. In fact, unless you're speaking apparatchik to apparatchik, you don't want to use the word "inflation" at all. It's just like Roosevelt essentially banning the word "regulation" from his Cabinet's vocabulary. Don't call it "regulation". Call it "cooperation", Roosevelt said, and even the grumpy old men will applaud. So today China calls it a "market malfunction" when their stock market deflates sharply (of course, inflating sharply is just fine). Better fix that malfunctioning machine! How can you argue with that language? But at least the political mandarins in the East are more authentic with their words than the political mandarins in the West. **Here we now call market deflation by the sobriquet "volatility", as in "major market indices suffered from volatility today, down almost one-half of one percent", where a down day is treated as something akin to the common cold, a temporary illness with symptoms that we can shrug off with an aspirin or two.** You can't be in favor of volatility, surely. It's a bad thing, almost on a par with littering. No, we want good things and good words, like "wealth effect" and "accommodation" and "stability" and "price appreciation". As President Snow says in reference to *The Hunger Games* version of a political utility, "may the odds be always in your favor". Who doesn't want that?

There are two problems with the odds being always in your favor.

First, the casino-fication of markets ratchets up to an entirely new level of pervasiveness and permanence. By casino-fication I mean the transformation of the *meaning* of market securities from a partial ownership interest in the real-life cash flows of real-life companies to a disembodied symbol of participation in a disembodied game. Securities become chips, pure and simple. Now there's nothing new in this gaming-centric vision of what markets mean; it's been around since the dawn of time. My point is that with the "innovation" of ETF's and the regulatory and technological shifts that allow HFTs and other liquidity game-players to dominate the day-to-day price action in markets, this vision is now dominant. **There's so little *investing* today. It's all *positioning*.** And in a capital-markets-as-political-utility world, the State is now actively cementing that view. After World War I, French Prime Minister Georges Clemenceau famously said that war was too important to be left to the generals, meaning that politicians would now take charge. Today, the pervasive belief in every capital in the world is that markets are too important to be left to the investors. These things don't change back. Sorry.

Second, if you're raising the floor on what you might suffer in the way of asset price deflation, you are also lowering the ceiling on what you might enjoy in the way of asset price inflation. That's what investing in a utility means – you're probably not going to lose money, but you're not going to make a lot of money, either. So to all of those public pension funds who are wringing their hands at this fiscal year's meager returns, well below what they need to stay afloat without raising contributions, I say get used to it. **All of your capital market assumptions are now at risk, subject to the tsunami force of status quo politicians with their backs up against the debt wall.** Their market-as-utility solution isn't likely to go bust in a paroxysm of global chaos, any more than it's likely to spark a glorious age of reinvigorated global growth. Neither the doomsday scenario nor the happy ending is likely here, I think. Instead, it's what I've called the Entropic Ending, a long gray slog where a recession is as unthinkable as a 4% growth rate. It's a very stable political equilibrium. Sorry.

As the title of this note suggests, we've been down this road before in the 1930s. But the historical rhyming I see is not so much in the New Deal policies that directly impacted the stock market as it is in the policies that established a real-life utility, the Tennessee Valley Authority (TVA). That's because the nature of the existential threat posed by overwhelming debt to the US political system was different in the 1930s than it is today. When FDR took office, the flash point of that systemic threat was the labor market, not the capital market. Sure, the stock market took its hits in the Great Depression, but the relevance of the stock market to either the overall economic health of the country or – more importantly to FDR – his ability to remain in office was dwarfed by the relevance of the labor market.

It's another one of those changes in meaning that seems bizarre to the modern eye or ear. What, you mean there wasn't 24/7 coverage of financial markets in 1932? You mean that most Americans didn't really know what a stock certificate was, much less own one? To succeed politically, Roosevelt had to change the meaning of the labor market, not the capital market, and that's exactly what he did with the creation of the TVA.

The TVA was only one effort in an alphabet soup of New Deal policies that FDR rammed through in his first Administration to change the popular conception of what the labor market meant to Americans. Other famous initiatives included the National Recovery administration (NRA) and the Civilian Conservation Corps (CCC), and the common thread in all of these efforts was a VERY active Narrative management embedded in their process from the outset, with photographers and journalists hired by the White House to document the "success" of the programs. Everything I write in Epsilon Theory about today's pervasive Narrative construction also took place in the 1930s, in amazingly similar venues and formats, down to the specific words used.

The Narrative effort worked. Not necessarily in the permanence of the institutions FDR established (the Supreme Court declared the NRA unconstitutional in 1935, and the CCC faded into obscurity with the outbreak of World War II), but in the complete reshaping of what the labor market meant to Americans and what government's proper role within the labor market should be. Yes, there were important things lost in FDR's political achievements (and plenty of grumpy old men to complain about that), but let's not forget that he was re-elected THREE times on the back of these labor market policies. If that's not winning, I don't know what is. And if you don't think that lesson from history hasn't been absorbed by both Clinton™ and Bush™, you're living in a different world than I am.

One last point on the TVA. It's still around today as a very powerful and oddly beloved institution, and I think its lasting political success is due in large part to the fact that it – unlike the other alphabet soup institutions – was explicitly a utility. Who doesn't like the stability of a utility in the midst of vast inequality? Who doesn't like the odds being ever in their favor? The more that I see today's policy impact on markets described in utility-like terms – words like "stability" and notions like "volatility is bad and a thing to be fixed" – the more confident I am that the TVA political experience of the 1930s is coming soon to the capital markets of today. Scratch that. It's already here.

So, Ben, let's assume you're right and that current events are rhyming with the historical events of the last time the world wrestled with an overwhelming debt load. Let's assume that a politically popular shift in the meaning of markets to cement its public utility function is taking shape and won't reverse itself without a political shock of enormous proportions. What's an investor or allocator to do, other than become a grumpy old man? Look, the hardest thing in the world is to recognize structural change when you're embedded in the structure. If reading Epsilon Theory has given you a new set of lenses to see the relationship between State and Market, then you've already done the heavy lifting. From here, it's a matter of applying that open-eyed perspective to your portfolio, not of buying this or selling that! Everyone will be different in their particular application, but I think everyone should have three basic goals:

1) shake out the category errors in your investment assumptions, understanding that we humans are terrible judges of causality, particularly when something has worked recently;
2) re-evaluate your capital market assumptions for a further transformation of those markets into state-run casinos and political utilities, understanding that whatever crystal ball you've used in the past is almost certainly broken today;
3) adopt an investment process or find investment strategies that can *adapt* to the structural changes that are already underway in capital markets, understanding that the patterns of belief and meaning we think are "natural" today can change in the blink of a central banker's eye.

Put simply, it's time for some good new thinking on some good old ideas like diversification. It's time to recognize the world as it is rather than lose ourselves in nostalgia for the world that was. Most of all, it's time to call things by their proper names and stop demonizing words like "leverage" and "volatility". These are tools, for god's sake, neither good nor bad in and of themselves, and they're tools we are all going to need to learn how to use if we want to be survivors in the Golden Age of the Central Banker. It's time to get to work.

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