Episode 879: Is There a Case for Bearishness? (Are We Always Bearish?)

Guest: Kevin Duffy

WOODS: I've got a few things that I'd like to talk to you about. Certainly I want to talk to you about current conditions. As we record this, it's the end of March 2017. But yet I'm still interested in talking about something that's, well, ten years old now, which is the onset — or at least getting to ten years — of the major, major problems with housing when the bubble began to burst, not only because I wrote a book on that, but also because you were one of the people who sounded the alarm at the time and said that there's something wrong. You and your firm were trying to tell people there's something wrong, and in those times it's hard to get people to listen. So I am curious about that.

But let me start off, though, in both cases you were a bear. You make the case for bearishness today and you made it at the time of the housing bubble. What do you say to somebody who says, The trouble with you Austrian-influenced financial guys is that you're always bearish, so of course you're going to be right when things go wrong? Why should I listen to you now? In fact, I had Mark Skousen on not too long ago to give the case on the other side, and he said, Look, I'm an Austrian, I know Austrian business cycle theory, but I think these people who are so bearish, they miss out on a lot of money. They leave a lot of money on the table. So how do you answer that?

DUFFY: I think it's a fair criticism, and we've certainly suffered over the last five years and had to do a lot of soul searching. What we realized is that we're part of this sort of Misesian, Austrian camp, and you can get too close to it. You can suffer from confirmation bias, where everything is negative and you focus on the negative side, which is the monetary inflation that's going on. And there's a positive side — it's always the market-driven deflation — that is incredibly bullish, and I think this is what we should be paying a lot more attention to.

I was looking at the last 20 years. The number of — Moore's law has played out. The number of transistors on a chip has gone up a thousand times. Bandwidth, the price of bandwidth has dropped by 99%. Genomic sequencing, it cost a billion dollars to sequence a genome in 2000. It's now under a thousand. So there are incredible opportunities on the long side for companies to get out in front of this deflation. It happened in the late 1800. It's happening today. So I think we are guilty of just focusing on all the negatives, and I think we need balance. But at the same time, we still have to pay attention to what's going on with the monetary inflation and the damage that that's doing.

WOODS: All right, I want to go back in time first before we talk about the present. Let's talk about the housing situation in 2003, '04, '05, '06. What was standing out to you as being unusual, unusual enough that you would issue a warning that there's something just systemically wrong with the housing market and the economy at large?

DUFFY: I think a lot of it went back to the tech bubble, and the response to the tech bubble was not to allow it to liquidate, even though the market did a pretty good job. I mean, Enron went bust. A lot of the online pet suppliers — I think there were 1,600 of them —

WOODS: Was it that many [laughing]?

DUFFY: Yeah, I heard that somewhere.

WOODS: That is really — that's a bubble. I mean, I'm no expert, but that's a bubble.

DUFFY: Yeah. And the response was to inflate, was to lower interest rates, and we saw — I think you had mentioned in one of your podcasts, Tom, that the bubble, the new money that's created goes into the next new thing, and so the old balloon sort of gets a hole in it, and it's replaced. So the new money doesn't go into the old dot-com companies that goes into the next new thing, and that happened to be housing, for whatever reason, and we can go back to the fact that the government was promoting it.

But for whatever reason, it happened, and so we started to see the excesses. And Christopher Mayer wrote a great article called "Mortgage Market Socialism," I believe in 2002, and he basically laid out the case that Fannie Mae and Freddie Mac were ticking time bombs. So we started our fund actually in 2003, and we took his advice and we started to follow what was going on and started shorting those two stocks. But then we could see the excesses building up, and it was just remarkable.

I think the Austrians did a great job of detecting what was going on, and this was — the money — So if you look at the tech bubble, you get these debt buildups during these bubbles, and there was $1 trillion increase in telecom debt that, most of it went bad. In the housing and credit bubble, there was about a $5 trillion increase in mortgage debt. So each of these bubbles has been — and then we could get into the current bubble, which is, we've had a $10 trillion increase in our federal debt — I mean, you could just go on and on about — it's parabolic. Each one of these bubbles, you get a greater and greater response. So those were some of the things that we saw back in 2005, '06, and '07.

WOODS: I was looking up that article, by the way, "Mortgage Market Socialism." I hadn't read that. And it's on the Mises Institute site. How about that? So it was a Mises Institute article that got rolling on this, and you're right, in 2002. How about that? So I'm actually going to link to that on our show notes page, TomWoods.com/879, if people would like to read that.

Anyway, all right, at the time, though, we can count on one hand the number of people who were saying something's wrong. The professional economists, forget about them. They were hopeless. But what did you find was the general — I mean, forget about people who were in the mortgage industry in one way or another. Like real estate people, forget those people. But in general, what were you seeing when you would go to cocktail parties? Was everybody really bullish? Didn't you run into people who said to you, "I've been around a little bit too long to fall for this one?"

DUFFY: It really depended on where you were. If you were in Harrisburg, Pennsylvania, there really wasn't a bubble. But I had a friend in Scottsdale, Arizona, and he was telling me about one of his neighbors who was in his early thirties and was basically becoming a mortgage mogul, buying up properties, of course on leverage. And my friend was trying to talk some sense into him. And when the downturn finally came, he basically doubled down. We just saw stories like that, where it was in places like Scottsdale, Arizona, it was in Southern California, South Florida, the stories. And this is something about bubbles that's really important, is there is a dichotomy. Not everybody takes the bait. Not everybody is seduced by low interest rates and is fooled. I mean, there are people who can step aside and act responsibly.

WOODS: So all right, so you called this. This has got to give you some bit of credibility. But since then, since 2009 and '10, we've had all kind of intervention. We've had fiscal policy; we've had monetary policy without precedent. And they can legitimately say, Look, we averted absolute catastrophe — well, let's take the word "legitimately" out. But they can plausibly to the guy on the street say, You can imagine that the economy could have gotten worse. You can at least imagine that. And we had this massive intervention and the economy didn't get worse, so maybe there's a chance we stopped that from happening. And today, look, the unemployment numbers are not too bad. They actually look pretty good. There are some numbers that look pretty decent. So if there are still bears around, that just goes to show you can't satisfy some people. What do you say to that?

DUFFY: So I think part of the problem is that we've had this incredible deflation and that we've had this recovery, this so-called recovery over the last eight years, which is real GDP has grown by about 2.1% a year. This has been the weakest by far of any recovery since World War II. And when you look at this incredible deflation, this natural, market-driven deflation, we should have had a lot more vibrant recovery.

You're also seeing, this is a global expansion. So we've had this boom in China and it's already — there was a commodity boom. It peaked in 2011. So we've already had this bust as a result of that. So it does show that the Austrian theory of the business cycle does work. I mean, you've got billionaires in Brazil that have been wiped out as a result of all of that. So it's not like the laws of economics have been repealed.

But we're already seeing — this is the thing that I try to tell clients — that this is not an event. It's kind of like the game of Jenga, where the longer it goes on, you keep on taking a block out and the system gets more and more fragile. So you were starting to see it in terms of, as short sellers, you look at some of the big debt buildups that have taken place. Companies — financial engineering — companies like Valeant Pharmaceuticals that were acquiring — it was a rollup model. They were acquiring all of these companies, and they took on $30 billion in debt, and the stock is down 90% over the last couple of years. So that — and they were not an isolation. It wasn't just

Valeant. I mean, there were all kinds of companies following this so-called platform model.

You're starting to see — and this is what happens in bubbles, is that you get these — the cracks start to appear. I mean, this is what happened back in 2006, 2005. In the first quarter of 2006, you had housing prices starting to decline, and yet the momentum kept taking the bubble a little bit higher and higher. So then you had the subprime cracks start to appear in February, March of 2007. And of course, the cracks start to appear, and what happens? The people ignore them, and the authorities say, Hey, don't worry, subprime is contained.

Well, we're seeing the same thing happen today, but it's really focused on the consumer. I mean, if you look at what's going on in retail, and I think this is obviously Amazon.com has something to do with it, but the middle class consumer is really in trouble, and there are cracks. You're seeing problems in the auto finance area. You're starting to see delinquencies go up. You're seeing delinquencies in student loans, was a big area of debt growth this cycle.

WOODS: Also, I think the average term of a car loan has gone way up to some unreasonable level.

DUFFY: It's gone way up, and used car prices have recently, in February they took their biggest drop since 2008. So it's a process. It's not really an event, and if you focus on the Dow Jones or the S&P 500 being 1% or 2% from all-time highs, you're missing what's going on below the surface.

WOODS: You know, you were saying that we should have had a more robust recovery. I kind of felt like the development of the Internet and its commercial potential and its — the Internet, smartphones, the things that these have done, what they've done for speed and productivity are incalculable. Things that I as an average person can now do are amazing. I can only imagine how fast and efficient things are now in the business world, where, boom, I can have a Skype webinar with people, some kind of a conference call all over the world. We can accomplish things really quickly. I always felt like that should have yielded an explosion in economic growth.

And you know, during the '90s when it was still very much in its infancy, you know, the growth was fine. But we haven't seen that, and I think that there probably has been an explosion in it, but that's been — this is just my theory. But I feel like there would have been if we hadn't had all these offsetting tendencies, government offsetting tendencies, the figures would be much higher. So I think that government is parasitically living off the high that we're getting from living through a revolutionary time, but the figures should be much higher than this in light of the absolutely revolutionary effects of the Internet and mobile devices and stuff.

DUFFY: I totally agree. And we've had this extreme — and it's similar to what happened in the 1920s, where it was all about stabilization of the price level, and prices should have declined in the 1920s, and yet there was this monetary inflation going on. And especially in the second half of the 1920s, prices were remarkably flat. It looked artificial how flat they were. But I think everything today is on a much greater scale, because when you look at bandwidth dropping by 99% in 20 years and you look at the massive deflation and how incredible — you're right, how incredibly bullish this is.

Jeff Tucker had written an article the other day about information, the idea that when we discover something, that information gets disseminated and it's basically there for everybody to benefit from. Well, if the cost of information is going through the floor and the cost of communicating that information is going through the floor, I mean, it's a very bullish event, so the fact that we've had a very anemic recovery and we've kind of hollowed out the middle class — and you're seeing this, these stress cracks in those areas — it has to make you question, Wait a minute, something is wrong with this picture.

WOODS: Tell me exactly in layman's terms what Bearing Asset Management does and whether your insights about the economy in some way govern how you make your decisions.

DUFFY: Well, it has a lot to do with our decisions. I think we start with really the two sort of tails of the distribution curve, and the analysis really starts with the good part, the positive lax ones, and that would be the deflation, but that also leads to the negative. So we're looking for mis-priced securities. We're looking for people who are kind of fooled. They don't understand, let's say, Austrian economics. They don't understand the true cause of the business cycle, that it's not a function of the market economy. And we see that there are companies that are really looking long-term, like on Amazon.com, and unfortunately we never invested in Amazon. It's a lesson that we learned.

WOODS: But Amazon is still barely — is it barely even turning a profit, though? Would you really be upset that you hadn't invested in it?

DUFFY: Yeah, I am upset, very upset, because I think it's trading at $800 a share, and when we started our business, it was about $25 a share.

WOODS: All right, okay, okay, for that reason I can see.

DUFFY: That said, they are generating a lot of free cashflow, and I think that this is something that people miss, is that companies like this are just — the results that they show are not really reflecting all the investing that's going on in the long-term plan, getting out ahead of these long-term secular waves. I think companies that do well tend to be the ones that are either riding a deflation, a natural, market-driven deflation, or are driving that, driving prices lower. And I think Amazon, to their credit, they got out ahead of this. Those are the types of companies that, A) as a short seller, you don't want to get anywhere near those companies, but B) they tend to be good investments. Dell, which was — Dell computer went public in 1988, a company we invested in. They were driving down computer prices, and I mean, talk about deflation. I mean, deflation is a good thing, and this is a company that the price of their product just kept going down and down and down, and the stock went up, from 1990 to 2000, probably went up a hundredfold.

WOODS: Give me your impressions of how Trump and his ideas fit into this whole picture.

DUFFY: Well, Trump is — I think part of the problem that Trump has to deal with is expectations. He is coming in with the stock market at all-time highs, valuations at high levels. He's inherited this bubble, and it's interesting, his first presidential debate, he called it a big, fat, ugly bubble. But Donald Trump got an economics degree from Wharton in, I believe, 1968, so he would have been exposed to a lot of these ideas about monetarism, monetary stimulus and fiscal stimulus. And I guess the part where they said that free trade is a good thing, he must have fallen asleep during that class.

But I think he's a chameleon. He's a marketing genius, and he told the people what they wanted to hear, that he was not an establishment politician. He was running against the establishment politician. And I think now that he is President Trump, it's no longer a bubble. It's now — he's measuring his performance based on the stock market, and when *Time* made him Person of the Year, in the interview, he said, Please measure my performance not based on January 20th when I take office, but when I was elected, because the stock market has gone up. So as an analyst, any time you see the CEO paying too much attention to his stock price, you get nervous.

WOODS: One other thing I wanted to ask you: I was reading the notes from your presentation, and you were saying, We all know there are certain fundamentals that go into a healthy economy, and you know, free market, sound money, all that stuff. But you said another ingredient for prosperity in the long term is delayed gratification, and you don't often hear it put that way, but as soon as you said, I thought, Yeah, if what you want is more stuff produced at lower prices, then a major ingredient for that is delayed gratification. But how? How exactly?

DUFFY: Right, so with the audience, I was looking at this and trying to — I knew I wanted to make kind of a basic economic case, because I was giving the bear case. And at the root of this is the fact that we've got these policies that promote consumption. So I wanted to look at the idea of, well, production comes first. I mean, it's the simplest idea going back to, say, Robinson Crusoe, where if he wants to build a net — I think you use that in one of your books, Tom. But if he wants to build a net, he's got to set aside some food, he's got to set aside coconuts. That's savings and investment. And so it's the simplest idea that there really is no human progress without delayed gratification.

And I cited the marshmallow test back in — this was conducted by a Stanford professor back in the late 1960s, and they took four- and five-year-old children, and they put a marshmallow or a cookie or something in front of them and said, Look, if you can stay here for 15 minutes when I leave, if I come back and you haven't eaten the cookie, we'll give you another cookie or a marshmallow. And they tracked these children — and by the way, about two-thirds could not resist the temptation. They had a very high time preference, as children do, and could not resist. But they tracked these children into adulthood, and they found that the ability to delay gratification was a key determinant to success, whether it be SAT scores, educational attainment, and even health-related, like weight-related problems.

So yeah, the idea is so basic, so fundamental, and then you look at the policies that we have towards stimulus: fiscal stimulus and monetary stimulus. It's all about consume, consume, consume first. And this is really a mistake. This is the same mistake that was made in the 1920s and then later in the 1930s to try to solve that mistake with the same mistake.

WOODS: Well, any time I talk to somebody — well, anybody like you or anybody who is in this world, I know the audience wants me to ask, What should I, the average Joe, do? And there are a lot of possible answers. I mean, I don't really do anything that super relies on the health of the stock market, even though you can make the argument that over the long term, the stock market does well. But sometimes, that's a really long term, so it is still somewhat of a gamble.

So what I've done instead is I just build up as many income streams as I can that seem sustainable over the long run. And even if one or two of them drop off, it's okay, because I've got nine or ten of them. That's what I'm shooting for. And those streams could be things like rental properties that yield me an income stream, or they could be affiliate programs for evergreen products that are never going away. Whatever it is, I want a bunch of them. I have five kids. I want to have a sustainable income and lifestyle for them, and so I have to be creative, and I don't want to fall for a financial fad or the next housing bubble or whatever it happens to be. So that's been my approach, and as I say, it does not rely on putting money in a 401K, it doesn't rely on the stock market. It just relies on using the old noodle and the extreme unlikelihood that every single income stream I've built up will just dry up.

So what kind of approach do you recommend? I mean, I suppose at Bearing Asset Management, you're not in a position where you're dealing with the average Joe every day, but you must think about it.

DUFFY: Sure. Well, I think investing is somewhat like amateur tennis. The idea is to not make a mistake. And so one of the things that we try to avoid is the herding effect. There's this temptation right now with reaching for yields. So for example, buying real estate investment trusts, especially mall-related RIETs and some of the office RIETs, and my advice is to just try to avoid doing things like that. Try to think in terms of these deflationary waves. Who is going to benefit from them, but who is going to be hurt? So the malls a great example, what's going on with retail. It's really about trying to anticipate the future. And if you're an Austrian and you understand that there is a business cycle, you see that there are companies out there that are trying to get rich too quickly. Their approach is they're resorting to financial engineering, and so a lot of this is just trying to look for the red flags, try to avoid some mistakes.

But then this creates opportunity as well. You have to be an opportunist, and you have to see that, let's say education, you see that the government is kind of destroying this and the cost of education is going through the roof and the value proposition isn't there. Well, there will be opportunities for somebody to come in an provide that through the Internet, through different means. So I think it's just trying to look at both sides, both the monetary inflation, who sort of takes the marshmallow, who's seduced by the marshmallow and is doing things wrongly and sort of in a short-term, get-richquick manner, and then looking at the natural, market-driven deflation, who's out in front of that, who will benefit. That's really what we try to do.

And then in between, I think another insight from the Austrians is the idea that when you do have this business cycle, that the bust when it comes is most pronounced in capital goods, capital-intensive companies. And so at this point in the cycle, you try to avoid those and you just try to — if you're going to invest, just try to stick to really defensive companies. We've got money invested in the poultry industry, for example. People will eat. They'll need to eat. So we've focused on that. We focus on things like fertilizer. So those are some ideas, Tom.

WOODS: Before I let you go, can I just ask you — maybe this is a trade secret or something, but you have to do a lot of research, you have to get a lot of raw data to stay on top of things and to make good decisions. How do you do that? What sources do you look to?

DUFFY: Well, there's so many. Gosh. *Barron's*, I've been a subscriber to *Barron's* forever. *Grant's Interest Rate Observer*, the provide a lot of data. There is — I mean, if you just get on the Internet, there are so many sources. Investing.com, they're a good source. Even the St. Louis Fed, FRED, that's an excellent source of information. I mean, we're swimming in information. There's so much great free information out there and it's wonderful. It makes this job so much easier.

WOODS: Well, I'm glad we had a chance to talk about all of this stuff. As you said before we went on, we could talk for hours and hours, but I just wanted to get your basic, basic take on the situation now. I was interested in the situation about ten years ago when you were warning there was something wrong, and every single thing you said was right on target. I'm glad also that you mentioned that Christopher Mayer article, which I hadn't known about, from 2002. Good grief. I mean, this guy is almost Ron Paul in his prognosticating ability. That's — because it was 2001 on the House floor that Ron Paul said, You know, they're substituting a real estate bubble for a tech bubble. I mean, just crazy [laughing]. The guy can see the future. I don't know what else to say.

But anyway, but also Kevin Duffy can see the future, and I'm glad we had a chance to talk. It seems like our paths haven't talked in an exceptionally long time at this point.

DUFFY: No, they haven't. I think the las time our paths crossed was probably in Houston at one of the Mises circles.

WOODS: That's right, yeah.

DUFFY: And also Colorado Springs. I have a signed copy of *Meltdown*, April 2009, and I remember your talk vividly because it was about the forgotten depression of 1920-1921.

WOODS: Oh, that's right. That's gotten like a quarter of a million views by now, that video. And I was somewhat heavier and I obviously need a haircut, so of all possible videos to get a quarter of a million views, naturally it had to be that one [laughing]. So anyway, all right, thanks a lot, Kevin. Let's make sure and get you on again soon.

DUFFY: Great, thank you, Tom.