JJ BURNS

WHY SMALL THINGS MATTER

A GRAIN OF SAND

Back in the mid-1980s, Commodore Computer Systems developed a mass-market computer that could be purchased at a local RadioShack. I remember my best friend scraping together enough money to buy one of these “revolutionary” systems, called the Commodore 64. One of the most interesting features of this device was its ability to solve complex mathematical equations.

Around the same time, a few physicists (Per Bak, Chao Tang, Kurt Weisenfeld) were studying how the dispersion of grains of sand created a sandpile. The physicists were able to use computers to model the relationship of how the random dispersion of each single grain of sand created a mountain of sand.

We all know from playing at the beach that as we add on more sand to a pile, it will ultimately create an avalanche or at least some type of fall out. In the sandpile game, a “critical state” seems to arise naturally through the randomness of the grains of sand being sprinkled. The physicists asked many questions, such as “could this phenomenon show up elsewhere.”

John Mauldin of MauldinEconomics wrote a piece on this phenomenon some three years ago and recommended a book by Mark Buchanan, called *Ubiquity: Why Catastrophes Happen.*

Buchanan explains, “As grains pileup it seems clear that a broad mountain of sand should edge slowly skyward and yet things obviously cannot continue in this way. As the pile grows its sides become steeper and more likely that the next falling grain will trigger an avalanche. Sand would then slide downhill to some flatter region below making the mountain smaller not bigger.”
-Mark Buchanan, Ubiquity: Why Catastrophes Happen

The physicists didn’t really care about the sandpiles. In studying this silly problem, they were chasing some insights into the general workings of non-equilibrium systems, i.e. eco-systems, earthquakes, war, stock market crashes, etc. The “sandpile” or non-equilibrium system represented a simple starting point so they might discover a pattern of behavior that would apply to a lot more than just sandpiles. Ultimately though, no one knows which grain of sand will ignite the avalanche.

CONTAGIONS

Cyprus, a single falling grain on the "sandpile", has made front-page news for the banking system collapse in their country. Cyprus is an island off the coast of Turkey about half the size of Connecticut. Its GDP is less than half of Rochester, New York. Pundits may argue that Cyprus is too small to matter. Cyprus is part of the European Union. The currency of Cyprus is the Euro. Cyprus does matter.

The way the European banking system has dealt with Cyprus giving minimal insurance to account holders (100,000 Euros and freezing more than 60% of assets in accounts), has systemic implications we are beginning to see and some that have yet to develop. The banking collapse will likely affect many businesses, people, and countries for some time to come. The way the Cyprus crisis is being handled may create a blueprint for other countries with troubled fiscal situations in the Eurozone.

History has repeatedly shown us that contagions start small. Right now, the markets show little respect for this fact and it is this widespread complacency which is concerning to us. Not too long ago a fellow colleague reminded me of how contagions typically begin. Here are a few recent examples:

1997-1998 CURRENCY CRISIS

There was not one but several factors which lead to the hedge fund collapse of Long Term Capital Management (LTCM). The collapse did not start with LTCM; in fact it ended with them.

The collapse actually started with the panicked trading of Thailand's currency, the "Thai baht", which lead to a contagion. The currency problem that started in Thailand lead to the Russian ruble collapse. After more than one year they brought in the US Federal Reserve Chairman Alan Greenspan to support the failed trades of LTCM hedge fund, as it would have potentially inflicted far more financial damage to our banking system. The process took nearly 2 years to play out.

WEIMAR REPUBLIC

A hat tip goes to economist Madeline Schnapp and David Kotok as my reminder from the recent missive entitled, "Contagions Start Small" in which this history was well documented.

The process of hyperinflation in the Weimar Republic started with the currency expansion and banking manipulation in an attempt to manage foreign-exchange flows. This began as an attempt to meet the requirements under the Treaty of Versailles. This did not immediately cause hyperinflation. In fact, it ended with hyperinflation and the demise of the government with the rise of Hitler and Nazism in Europe.

When Germany went to war in 1914, an egg cost 2 pfennigs and a loaf of bread was 10 pfennigs. With the birth of The Weimar Republic in 1919, both the egg and a loaf of bread were 20 pfennigs.

In April 1922, the egg was 4 marks (100 pfennigs formerly equaled 1 Deutsche mark in Germany). By September, it was 9 marks and November, 22 marks. In July of 1923, an egg was 20,000 marks and by August it was 200,000 marks. Remarkably, the price continued higher through 1924 when a loaf of bread reached 1 trillion marks.

US FINANCIAL CRISIS

Looking back, the US financial crisis showed some initial signs of weakness in the beginning of 2007. Wide swings in asset price were ignored and money movement within lending markets was suspect. Since everyone was "making money", nobody cared if the borrower could pay it back. Until one day, when the markets came to realize the foundations of the expansion were built upon a pile of sand. The issues started out small then became larger as time progressed.

CAN THE AFFECTS ON CYPRUS ONLY BE LIMITED TO CYPRUS?

To give some perspective, businesses in Cyprus import goods for consumers. If a business has one million euros in a Cypriot bank and they are only able to access less than a third, (Eurozone mandate) then how will this business function or even meet its payroll to run "normal" operations. It is possible this crisis will be a trigger for other events in the Eurozone. In order for the governments in Cyprus to receive European rescue funds, it will effectively, have to collapse its financial system. The bond and shareholders of Cyprus' two largest banks will lose all. Depositors will get the protection of insurance up to the first 100,000 euros. Thirty to forty percent of the unprotected amount will be converted into shares. The smaller insured deposits and viable assets of the island's second largest bank, the Popular Bank of Cyprus (also known as Laiki bank) will migrate to the Bank of Cyprus. This infusion of liquidity and assets should make it viable. Laiki Banks will be shut down. Market participants in adjoining countries are already moving funds to safer regions.

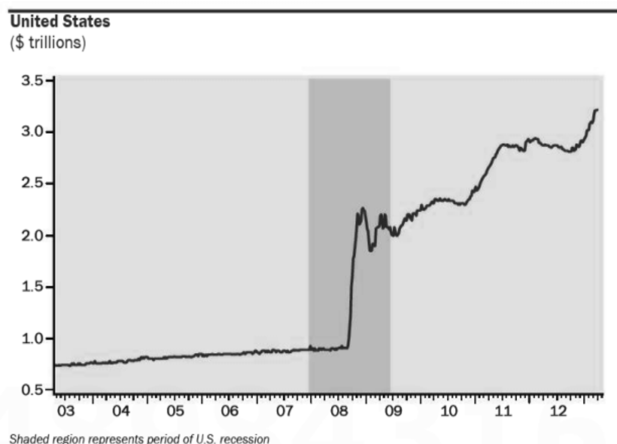
As a backdrop, this past Friday brought news that banking/brokerage houses will not guarantee money market Euro deposits any longer. This means the 1.00 Euro money market share net asset value can decline, or drop below its previously stated guarantee. Spain and Italy are seeing monies leave their countries, as they are also troubled. Unemployment in Spain hit 26% in the first quarter of 2013. Youth unemployment is over 50% in Spain. Unemployment in the Eurozone is at 12% even though Central banks continue to keep cheap money flowing.

A WORLD OF CHEAP MONEY

The Bank of Japan was top news at quarter end with its pledge to double the monetary base by much of the same as the Federal Reserve is doing. Globally, central banks are utilizing highly unconventional policies to ease credit, which may go a long way to reflating asset bubbles. In the beginning of this quarter, the Fed affirmed it would continue with $85 billion per month of

stimulus until the unemployment rate drops to 6.5% (more on this below). This process does little to increase economic growth. As The Economist recently wrote, "the low rate world was not meant to last". In 2008-2009, when central banks slashed short-term rates close to zero and started buying bonds to push down longer term rates, everyone assumed these extraordinary measures would soon be unwound as economies recovered."

FED BALANCE SHEET

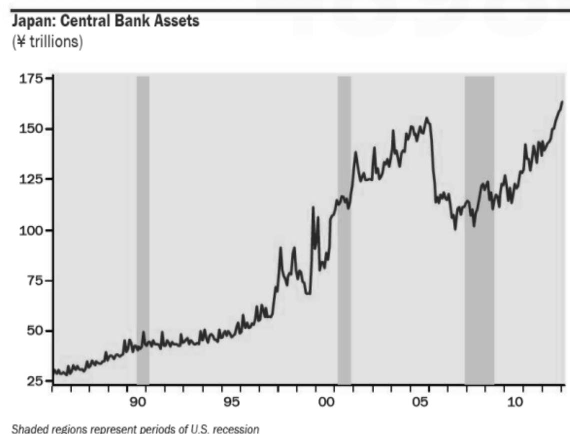


Similarly, Japanese interest rates have been near zero for over a decade. The new finance minister, Mr. Kuroda has thrown all the money he can into the Japanese economy in an attempt to have businesses invest in Japan. This attempt is a last ditch effort to get businesses to invest by growing and building. Sound familiar?

Businesses do not invest because the economy is weak. The economy remains weak because businesses do not invest. Awash in monetary supply, with more on the way, this strategy has been reaffirmed by most central banks globally. This is one reason why stocks are increasing. The way this is supposed to work, or at least the way the Fed wants it to work, is low interest rates are supposed to spur economic growth. This policy is supposed to ignite growth, not discourage it. Unfortunately, the exact opposite is occurring.

Businesses are concerned about the growing US National Debt and know it is just a matter of time before policies need to be put in place to deal with the problem. These policies will most likely crimp growth, so most businesses are hoarding cash in anticipation of a weak economic cycle ahead. They are vowing not to be caught in the near death experience they suffered through in 2008.

JAPAN: CENTRAL BANK ASSETS



Make no mistake; the cheap money provided by the Fed has benefited some parts of the economy:

1. Refinancing: Lower mortgage rates increases savings in consumers' pockets. Last year mortgage originations were up nearly 40%.

2. Home Sales: Existing home sales were up over 4.5mm last year.

3. New home construction: 366,000 new homes were built last year. The first increase since 2005.

4. New Home Permits: More new homes on the way. New home permits hit nearly 1,000,000, the most since mid-2008.

5. New Car Sales: Increased by 13.4%, the highest since 2007.

6. Increased Expenditures: Higher home prices and purchases increases related spending for homes. An average home purchaser spends at least $10,000 on improvements and furnishings.

Unfortunately, these are all consumer based uses of credit for consumption, not sustainable use of credit for growth related activities. The Fed is working feverishly to reflate asset prices to fill the hole blown in the economy by the Credit Crisis of 2008.

We believe it is important to know history. Going back to the earlier discussion about Thailand, an important point in financial history occurred there in the mid 1990's. A property fueled rally ensued in Thailand, driven by very low interest rates and "cheap money" loans. This ultimately ended in Thailand devaluing it's currency which lead to other global financial problems.

The concerns we continue to have in our investment policy team meetings and throughout our due diligence process is how excessively low interest rates over long periods help to create asset bubbles. Investors tend to ignore the cost of financing and concentrate on capital gains if their strategy works. People forget risk and focus too much on reward.

The goal of low interest rate policies is to spur economic activity. It is to encourage businesses (with low borrowing rates) to invest in long term projects which will ultimately increase hiring and get the employment rate to grow "organically". In fact, many multinational companies are utilizing the low interest borrowing costs far more cheaply than other countries.

FED EXPECTATIONS

A recent example, cited in the Economist, explains this perfectly: Procter & Gamble pays 2.3% on its 10-year bonds, whereas Italy pays 4.6%. Large multinational companies are grabbing significant levels of low interest funds. Corporations are issuing bonds in record sums. In fact, corporate bond issuance has topped new highs since 2009, over $2 Trillion.

Ideally, what the Fed wants these businesses to do is commit to long-term growth projects. On the contrary, what corporations are actually doing is refinancing their debt and utilizing the low interest rates to reduce the amount of stock by purchasing their own shares.

If the longer-term economic climate does not look good, and we have clearly embarked on an economic path which has never been tested, then businesses will hesitate to invest at a time when consumers are retrenching and many businesses are not in an expansionary mode.

This does not mean that every sector in the economy is performing poorly, nor globally are sectors around the world going down collectively. Businesses are utilizing their labor far more productively and the same businesses are investing in technology. Furthermore, low interest rates bring other spending to parts of the economy as indicated above. The reality is low interest rates are not bringing our economy to a natural level of organic growth brought about by real investing and capital expenditures.

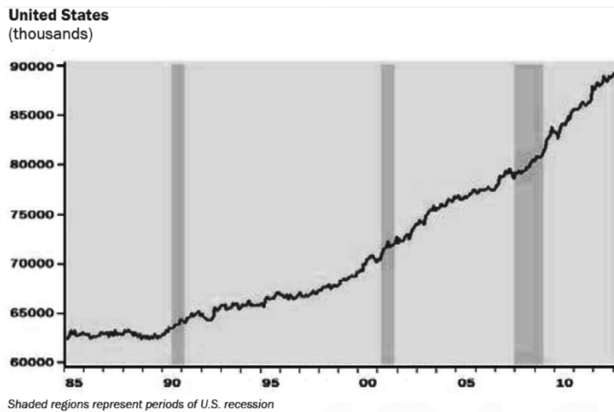
When it comes to job growth, last Friday we received the much anticipated employment report, which showed a weakening of job creation. Payrolls came in at a very small 88,000. Our economy requires a minimum of 250,000 "new" jobs per month in order to maintain pace with demographics (essentially a "push" in job creation). In healthy recoveries, we would typically see job creation of 300,000 to 500,000. It is not surprising to us that the unemployment rate dropped to 7.6% from 7.7%, the lowest it has been since December 2008. The reason for this is a decrease in the participation rate, which is the measurement of people who are simply discouraged and stop looking for work.

CIVILIAN PARTICIPATION RATE

The participation rate typically rises during recessions. Once again, this month the participation rate declined indicating worker discouragement and the dropping of job seekers. The labor force plunged by nearly 500,000 participants. Employment went down over 200,000 and the employment/population ratio was down at its lowest level since August of last year.

The number of people not counted in the labor force on these figures is nearly 700,000. As people stop looking for a job, they are no longer counted. Therefore, not being in the number pushes the unemployment calculation down. Add up the one million in the past three months and it now stands at 90 million unemployed and many no longer looking for a job. Economist Dave Rosenberg in his recent analysis summed it up perfectly, "who are these people and how are they getting by?"

LABOR FORCE



Shaded regions represent periods of U.S. recession

FINGERS OF INSTABILITY

Getting back to our sandpile example or non-equilibrium systems, we believe it is critical to understand that every avalanche in the sandpile game, large or small, starts out the same way. When a single grain falls and makes the pile just slightly too steep, at some point the avalanche occurs. What makes one avalanche much larger than another has nothing to do with its original cause, and nothing to do with some special situation in the pile just before it starts. Rather, it has to do with the "perpetually unstable organization of the critical state", which makes it always possible for the next grain to trigger an avalanche of any size. It is important to stress these declines may not always happen in a precipitous way, but nonetheless they do and can occur. The experiment the Fed has embarked upon has not been tested, which is ultimately the reason a well-informed investor can better understand why broadly diversified portfolio structures need to be maintained. Throwing caution to the wind and diving straight into the sand pile is the best way to get buried alive.

At JJ Burns & Company, our strategy is to emphasize broad asset class diversity while measuring risk versus reward. We remain diligent in this process and will not deviate from seeking reasonable portfolio levels of return with less risk. A portfolio that is not diversified always feels good when it is going up, but when the sand shifts and the market trembles, it is always nice to know that there is a firm foundation not too far below supporting you. The key to long term investment success involves patience. Perhaps with the arrival of spring, it will also be the renewal of growth. We will see.

On behalf of our entire team at JJ Burns, we wish you a happy spring.

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