

LMR

BUILDING THE 10%

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THIS MONTH'S FEATURES



THE FED RATE HIKE

BY ROBERT P. MURPHY

The Fed rate hike went hand in hand with a tanking stock market. Not a coincidence.



POSITIVE THINKING, POSITIVE ACTION —POSITIVE CASH FLOW!

BY L. CARLOS LARA

There's a lot of mumbo jumbo in motivational thinking, but here we isolate the element of truth.



OIL PRICES AND THE BUSINESS CYCLE

INTERVIEW

Bradley is an Austrian economist with decades of experience in the oil and gas sector. He gives us the big picture.

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DEAR READERS

LARA-MURPHY REPORT

We must never give up trying to persuade our neighbors, but we must also be realistic.



ECONOMIC DEEP END

PULSE ON THE MARKET

China Treasury Dump • S&P Credit Warning • MetLife Spinoff



ONE MORE THING

EVENTS AND ENGAGEMENTS

Learn more in person from Lara, Murphy, and other Austrian economists, at these upcoming appearances.



ABOUT LARA & MURPHY

L. CARLOS LARA is CEO of United Services and Trust Corporation, a consulting firm specializing in business advisory services with a primary focus on working with companies in financial crisis. His background in capital formation and business rehabilitation makes him a regular speaker at credit and business conferences.

In 2010 he co-authored the highly acclaimed book, *How Privatized Banking Really Works* with economist Robert P. Murphy.

He is a co-creator of the IBC Practitioner Program for financial professionals and sits on the board of the Nelson Nash Institute.

ROBERT P. MURPHY is Research Assistant Professor with the Free Market Institute at Texas Tech University. He is co-author of *How Privatized Banking Really Works*. He is the author of *Choice: Cooperation, Enterprise, and Human Action* (Independent Institute 2015) and co-host with Tom Woods of the popular podcast *Contra Krugman*.

Murphy has a Ph.D. in economics from New York University. After spending three years teaching at Hillsdale College, he went into the financial sector working for Laffer Associates. With Nelson Nash, Carlos Lara, and David Stearns, Murphy is co-developer of the IBC Practitioner Program.

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***“There is no use decieving ourselves.** American public opinion rejects the market economy, the capitalistic free enterprise system that provided the nation with the highest standard of living ever attained. Full government control of all activities of the individual is virtually the goal of both national parties.”*
—Mises

It has been said many times before— the real threat to the U.S. will not come from abroad. Public consent is the all-prevailing power that will stir the nation this way or that. If we are to have any influence over the thinking of the people and redirect their present course we will need to convince a large portion of them that our way is the best.

Yet before we get too full of ourselves and go preaching what we believe is the final say on social and economic matters, we should remind ourselves that it is impossible to coerce people against their will. The masses must be openly receptive to our message by seeing it as a sound alternative to their present individual circumstances.

Sound economic principles and their theories must be communicated properly using the intellectual means. A classroom type setting using properly trained educators has always been an excellent method, but so are books, tracts, pamphlets, seminars, websites, videos, podcasts, and all manner of modern transmission.

In addition to this, and what we see as an overlooked approach, is that both the educator and the one being educated must be personally incentivized to move in the direction of the teaching. This we see is the role of the properly trained financial professional. Such a person must first understand the basic tenets of the Austrian School of Economics. In this way when meeting with clients the financial professional is able to discuss, not only the client’s own personal financial circumstances, but also educate them about the broader macro aspects of the economy and how they are intrinsically tied.

Evangelizing our message using this combined effort allows us to accelerate the educational process and reach the desired goal of “the ten percent”—who can then tip public opinion. As always, we are grateful for your continuing support and fellowship in its achievement.

Yours truly,
Carlos and Bob

“It is the masses that determine the course of history, but its initial movement must start with the individual.”

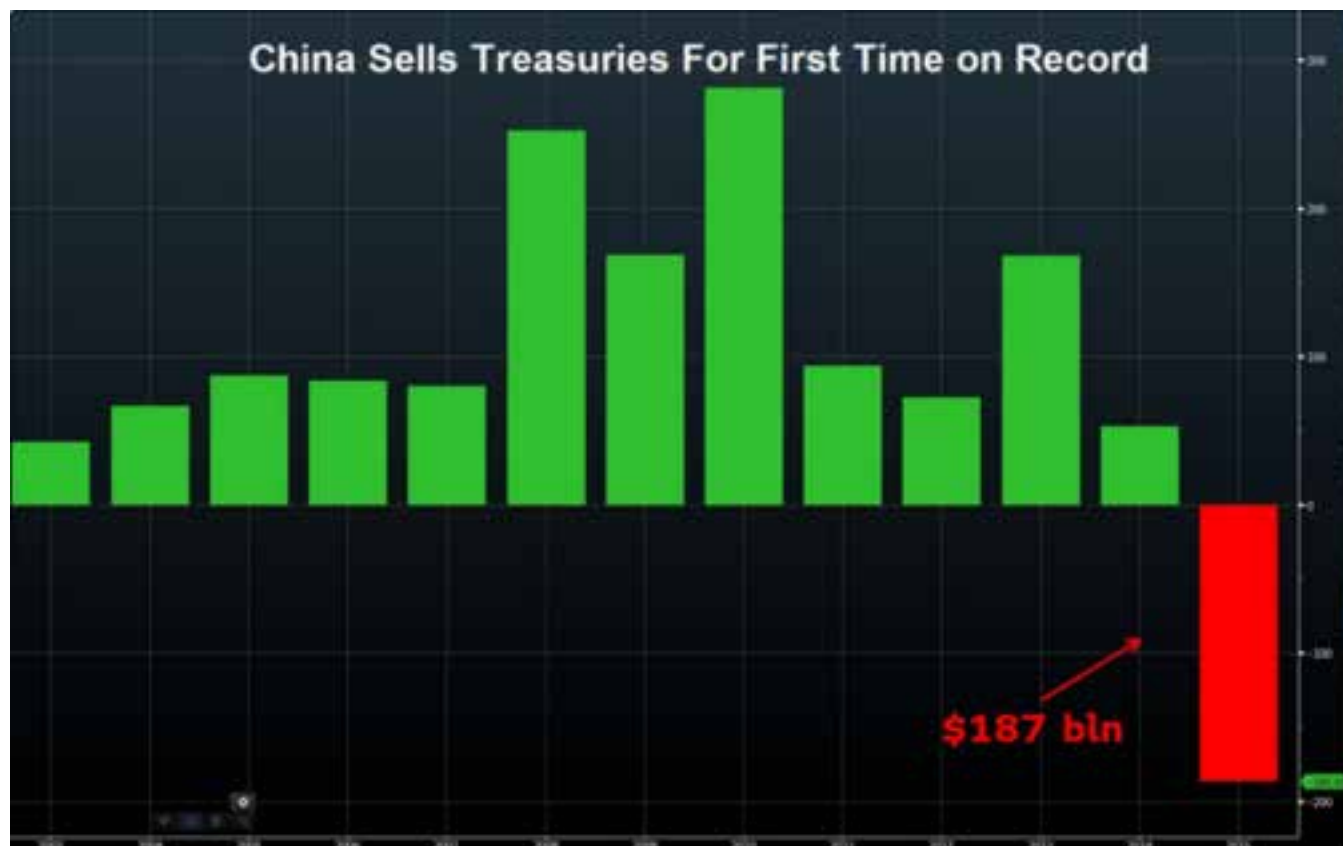
— How Privatized Banking *Really* Works

PULSE ON THE MARKET

CHINA TREASURY DUMP

“THE IMPOSSIBLE” CONTINUES TO UNFOLD

Long-time readers of the LMR know that we have long warned that the U.S. dollar's hegemony in world currency markets was a revocable privilege, and that irresponsible Fed policy was sowing the seeds of a future blowback. Specifically, so long as investors, governments, and central banks around the world were willing to tie their own currencies to the USD and/or absorb dollar-denominated assets as if they were akin to gold, the U.S. could run a balance-of-trade “deficit without tears” (the memorable phrase coined by French economist Jacques Rueff in the postwar era). However, once the spell had been broken (for whatever reason) and foreigners were not willing to indefinitely pile up more and more claims on future dollars, there would be an effective margin call on the U.S. standard of living. In this respect, we were not pioneers, but instead were echoing a long line of caution coming from the opponents of unbacked government fiat money.





PULSE ON THE MARKET

For years, critics pooh-poohed warnings such as these, saying (for example) that the world had no alternative but the USD. Well, as we explained in the December 2015 issue, the IMF recently added the Chinese currency to its basket of “reserve currencies.” Meanwhile, in a Jan. 10 Bloomberg article by Andrea Wong, we see the above chart regarding Chinese selling of Treasuries last year:

The funny thing is, rather than sounding the alarm, the Bloomberg article dutifully quoted all sorts of analysts to assure its readers that things were fine. After all, with the world possibly tilting into recession, investors will be flocking into “safe” Treasuries. Notice the irony here: The narrative is admitting that something really disturbing is happening, but that its normal impact will be masked by the slumping of the global economy. Are you reassured?

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METLIFE SPINOFF

METLIFE TO SEPARATE U.S. RETAIL LIFE INSURANCE UNIT

The largest U.S. life insurer—with 2014 assets of more than \$608 billion—announced this month its plans to separate its retail life insurance unit. The decision was driven at least in part by the new regulatory environment. A CNBC story by Everett Rosenfeld quoted MetLife CEO Steven Kandarian explaining: *“Even though we are appealing our SIFI [Systemically Important Financial Institution—eds.] designation in court and do not believe any part of MetLife is systemic, this risk of increased capital requirements contributed to our decision to pursue the separation of the business...An independent company would benefit from greater focus, more flexibility in products and operations, and a reduced capital and compliance burden.”*

This development fits in with the warnings that Carlos has been issuing from these pages. (See for example his articles, “Bank Deposits Are RISKY” [May 2014], “From Bail-Outs to Bail-Ins” [February 2015], and “First Cyprus, Then Greece: Now It’s Time to Save Cash AT HOME” [July 2015].)

We know that many of our subscribers work in the life insurance sector, and to that end we underscore that a de facto federal takeover could be in the wings via broad-based “contagion” regulation. For example, a December 2013 Pricewaterhouse-Coopers notice explained: *“The designation of AIG,*



PULSE ON THE MARKET

Prudential, and GE Capital as systemically important nonbank financial institutions shows that federal oversight can be exercised without significantly changing the state insurance regulatory system.” To be clear, the PwC notice was arguing that there would not be a major Congressional overhaul of life insurance regulation, since Dodd-Frank had already given the feds the power they needed...but that’s our point, too.

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S&P CREDIT WARNING

COMPANY DEBT OUTLOOK WORST SINCE THE FINANCIAL CRISIS

A Jan. 13 CNBC article by Katy Barnato reported, “Pressure on global corporate credit ratings is at the worst level since the financial crisis, Standard & Poor’s (S&P) has warned.

...[T]he ratings agency said that 17 percent of debt-issuing companies were on “negative credit watch” at the end of 2015, meaning they had a 50 percent chance of being downgraded within the next three months. This outnumbered the number of companies on “positive credit watch” by a ratio of three-to-one.”

With the era of ultra-low interest rates finally coming to an end, we are (unfortunately) about to see how much of the apparent “recovery” in the last seven years was really built on unsustainable debt.

THE FED RATE HIKE

by
Robert P. Murphy



A MOMENTOUS EVENT LAST MONTH WAS the Fed's decision to hike its target for the federal funds rate. Since December 16, 2008 the Fed's target for this particular rate had been a range of 0 percent – 0.25 percent (or what is referred to as zero to 25 “basis points”), but last month on December 16 they moved that target range up to 0.25 – 0.50 percent.¹ Thus the period of effectively zero percent interest rates—a time of “plenty”?—lasted *exactly seven years to the day*, which may unsettle those readers who don't believe in coincidences.

In the present article I'll explain the significance of the move, especially as it relates to the horrible stock market opening this year and the broader business cycle. I will also fill in details about why this particular cycle of Fed tightening is unlike anything before. As we'll see, the Fed is “raising rates” this time *not* through the usual mechanism of sucking money out of the system, but instead it is increasing the *subsidies to commercial banks* to effectively bribe them to not make loans to their customers.

The Fed and the Stock Market

Long-time *LMR* readers know that Carlos and I have been warning that the stock market (and broader economy) rested on a house of cards, inflated by the Bernanke Fed in the wake of the 2008 financial crisis. For the benefit of those who may have missed it, let me reproduce some text and a crucial chart from my article last September:

“As the August issue of the Lara-Murphy Report was going to publication, the U.S. stock market suffered massive gyrations, with the S&P 500 erasing all of its gains from the prior 16 months. The market's volatility continued through September, with several days seeing moves of 1 percentage point or greater. Perhaps even more alarming, after the Fed postponed a rate cut in its pivotal September meeting, the market fell yet further.”

For those who have been following the LMR for years, these movements are not a surprise. If anything, our loyal readers may have been wondering how long the Fed and other central banks could keep the rig afloat.

In the present article, I'll provide evidence from the past two crashes to suggest that the worst is yet to come. Even if the Fed launches another round of quantitative easing—which I still don't expect to occur—it will merely postpone the inevitable crisis, and make it that much worse.” —Robert P. Murphy, “The U.S. Stock Market: The Worst Is Yet to Come,” September 2015 issue of the *Lara-Murphy Report*

Long-time LMR readers know that Carlos and I have been warning that the stock market (and broader economy) rested on a house of cards.



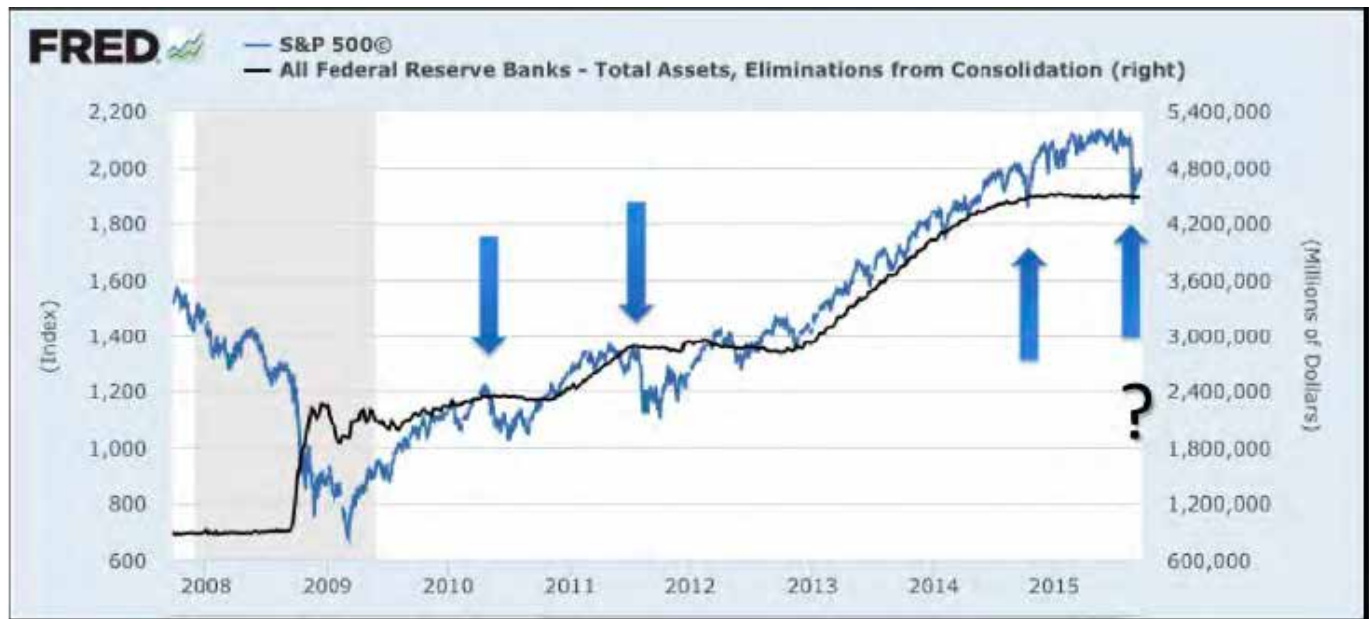


FIGURE 1. STOCK MARKET VERSUS FED'S BALANCE SHEET, 2007 - 2015

In the chart above, I was showing *LMR* readers that that S&P 500 Index (blue line) had tracked the Fed's total asset holdings (black line) very closely since the Fed's extraordinary interventions began in the late fall of 2008. The big blue arrows in the chart show that the stock market fell sharply every time a round of quantitative easing (QE) ended—meaning the black line leveled off because the Fed had temporarily stopped buying net assets—or, in the case of the last big drop with the question mark, where the markets feared a rate hike. (That last big drop in the chart occurred in August 2015, when the Fed had been planning to have the first rate hike in the next month.)

In light of the above analysis, it certainly is no shock to now see U.S. equity markets tanking, after the first rate hike actually went into effect.

The Austrian Theory of the Business Cycle

Let me assure new readers that Carlos and I are by no means “chart followers.” We subscribe to the so-called Austrian School of economics, and in particular its theory of the business cycle developed by Ludwig von Mises and Friedrich Hayek. Space doesn't permit me to do justice to the theory here, so interested readers should consult our book, *How Privatized Banking Really Works*.

However, in a nutshell, the Mises-Hayek theory says that in a market economy, interest rates perform a definite social function. They communicate information about the amount of savings, as well as consumers' desires for the timing of consumption, so that entrepreneurs can make relevant calculations when deciding whether to embark on particular projects. Loosely speaking, a low inter-

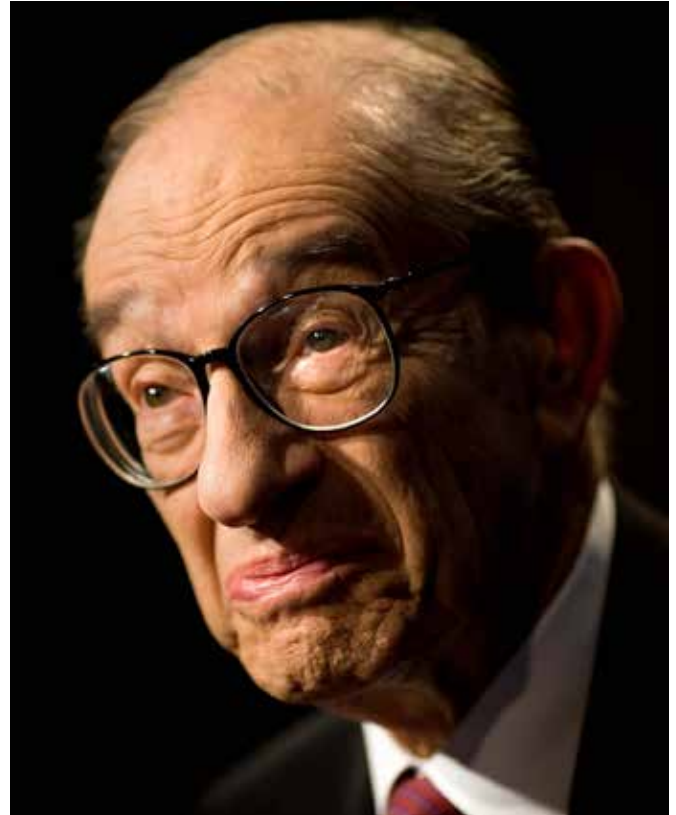
Former Fed chair Alan Greenspan made a terrible mistake when the dot-com bubble burst in the early 2000s.

est rate is a green light to longer production processes (where the invested capital will be tied up for a longer time), while a high interest rate is a red light, telling entrepreneurs to sink capital into shorter projects.

According to many modern Austrians, former Fed chair Alan Greenspan made a terrible mistake when the dot-com bubble burst in the early 2000s. Instead of letting nature take its course, Greenspan's Fed slashed interest rates down to 1 percent (which was very low for the time) by June 2003. This helped fuel the real estate boom, effectively replacing the dot-com bubble with one in housing. A year later, the Fed began raising rates again to stem price inflation, and thus began the deceleration and eventual crash in housing prices.

Storms Ahead: Take Shelter

If the Austrian framework I've described sounds plausible, then the reader can understand why Carlos and I have been so alarmed by Fed chair *Bernanke's* policies once he took the keys from Greenspan. After the financial panic in September 2008, the Fed slashed rates all the way to *zero* percent, and held them there for seven years. But beyond the movement in interest rates, the Fed also mas-



sively expanded its balance sheet, with assets jumping from \$900 billion in August 2008 to \$2.2 trillion by the end of 2008 (!) and more than \$4.5 trillion by December 2014.

In light of this predicament, Carlos and I have been urging audiences—in both print and live presentations—to diversify their asset holdings, obtaining “cash” and hard money (such as gold or silver). We are fans of Nelson Nash's Infinite Banking Concept (IBC), which uses specially designed whole life insurance policies, as the best method for Americans to warehouse and manage their flow of U.S. dollars.

Carlos and I both think major storms are on the horizon, and within that metaphor we might say that the rain is already pouring down upon us. We are not picking particu-

We are fans of Nelson Nash's Infinite Banking Concept (IBC), which uses specially designed whole life insurance policies, as the best method for Americans to warehouse and manage their flow of U.S. dollars.

lar assets as “winners,” but instead are giving a framework for people to play defense against the threats to their wealth in the coming decade. Naturally, we are not giving formal investment advice, but instead are trying to explain the forces at work in the broader economy. Interested readers should of course consult with qualified tax and investment advisors before making any important financial decisions. For those wanting to discuss IBC and its application to their own household or business, I point to the IBC Authorized Practitioner Finder at: www.InfiniteBanking.org/Finder. The people on this list have passed the course and satisfied the other requirements for the training program

established by Nelson Nash, David Stearns (who runs Infinite Banking Concepts), Carlos, and myself.

Interest Rate Moves

In addition to bumping up the federal funds rate, the Fed's actions have caused interest rates across the board to move up. The effect is more pronounced for shorter-term rates. Anticipating the rate hike, markets have steeply increased yields on 3-month and 1-year Treasuries in recent months:

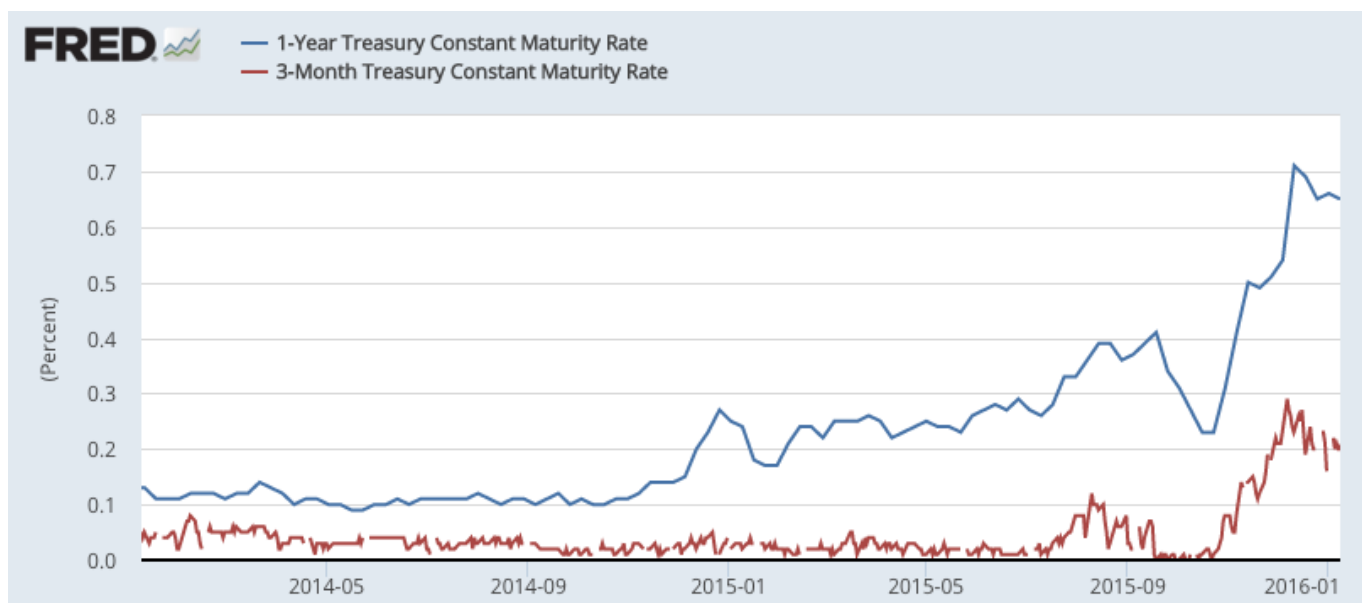


FIGURE 2. SHORT-TERM RATES SPIKE



The rate hike is putting a squeeze on some high-yield bond funds, whose investors are realizing that these “junk bond” funds are not nearly as liquid as they previously thought.

As Figure 2 indicates, short-term Treasury yields began rising in the summer, presumably because markets expected the Fed to hike in September. Then the yields collapsed after the August stock panic and the Fed’s decision to postpone the September hike. However, as things settled down and markets were growingly confident that the hike would occur in December, we saw rates rise to more than triple what they had been earlier in the year.

The *absolute* movement in short-term yields

is fairly modest, but the relative increase may have serious impacts on firms that are highly leveraged, and had an investment strategy based on rolling over large amounts of short-term debt. Among other effects, the rate hike is putting a squeeze on some high-yield bond funds, whose investors are realizing that these “junk bond” funds are not nearly as liquid as they previously thought.

In Figure 3 below I show the yields on a spectrum of Treasury securities.

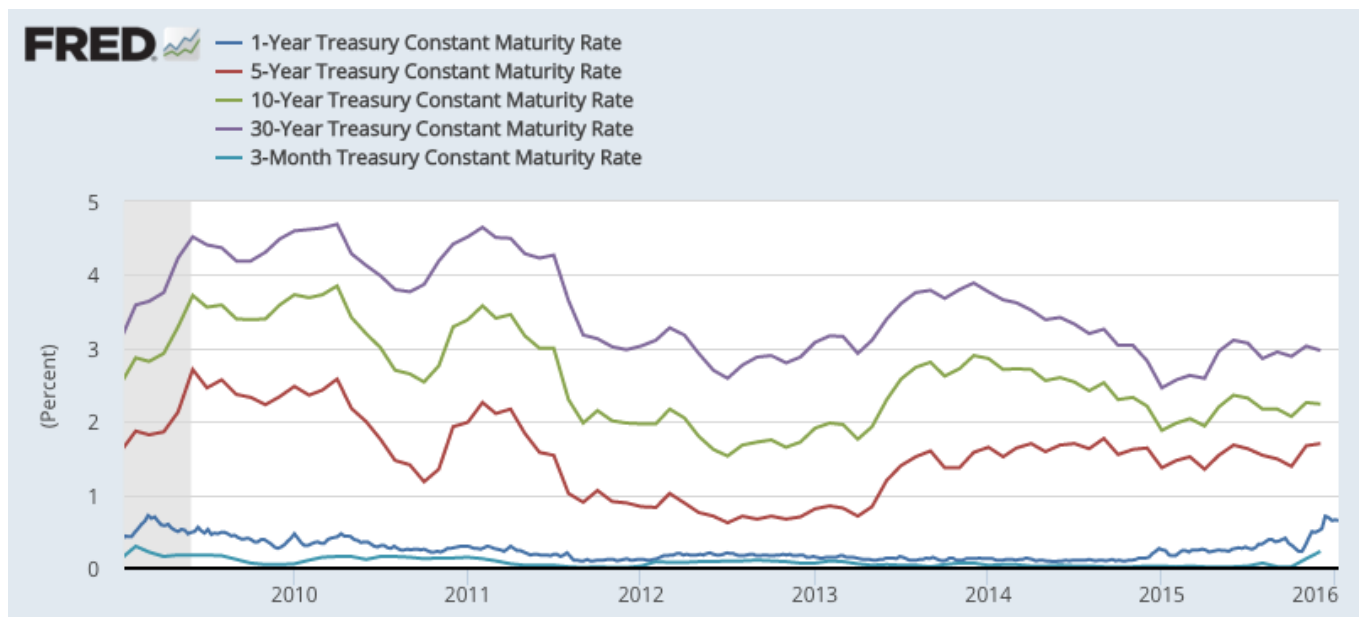


FIGURE 3. YIELDS ON TREASURIES OF VARIOUS MATURITIES

Figure 3 shows that the entire Treasury yield curve has shifted up, but the effect is more pronounced at the short end. (This is standard financial economics: Long-term Treasury yields reflected expectations of short rates eventually being hiked, so the precise timing of the Fed's first hike wouldn't move the 30-year yield as much as the 3-month yield.)

Figure 3 also shows that the 3-month and 1-year Treasury yields are now the highest they've been since 2009, the 5-year is the highest since 2011, but the 10- and 30-year yields are still lower than they were earlier this year. The conventional explanation for this pattern is that the Fed rate hike is the predominant factor for the shorter-term securities, while the worsening economic outlook is reducing forecasts of long-run growth, meaning that investors are willing to accept lower yields on longer-term Treasuries because of pessimism about the future economy.

In one sense, I welcome the Fed's rate hike, and the consequent (if modest) rise in other interest rates. The rock-bottom rates since late 2008 have been an absurdity, preventing crucial market prices (i.e. interest rates) from doing their job of communicating information to producers and consumers.

Those who have thought the U.S. economy was being artificially inflated the past few years should expect things to continue unraveling.

However, standard Austrian business cycle theory says that typically the "bust" phase ensues once the banks begin raising rates. Those who have thought the U.S. economy was being artificially inflated the past few years should expect things to continue unraveling, unless the Fed rushes in with new money to (once again) postpone the inevitable crash.

The Actual Mechanics of the Fed Hike

In this final section of my article, let me explain some of the actual mechanics for how the Fed is hiking rates. It is *not* a textbook maneuver. We are still in uncharted territory as far as central bank operations.

Normally, when a central bank wants to "tighten" and raise interest rates, it sells off some of its assets. For example, if the Fed sells \$10 million of its mortgage-backed securities to JP Morgan, then JP Morgan writes a check to the Fed for \$10 million. On JP Morgan's balance sheet, its assets are unchanged, except for their composition: their holdings of mortgage-backed securities go up by \$10 million, while their reserve balance on deposit with the Fed goes down by \$10 million. (You can think of it as JP Morgan having a checking account open with the Fed.)

However, things are different on the Fed's side. (To repeat, we are right now talking about a *normal* or *typical* open-market op-

eration when the Fed wants to tighten. Once we review these details, I'll explain what's going on *right now* and how it's different.) Since leaving the gold standard, there are no real constraints on the Fed's operations. Even so, formally, in terms of the accounting, an outside entity's reserve balances are still considered a "liability" on the Fed's books. So if, in our hypothetical scenario, JP Morgan writes a check to the Fed, drawn on JP Morgan's checking account with the Fed, what happens is that the Fed simply reduces its liabilities by \$10 million. It simultaneously reduces its assets by \$10 million (because it sold off some of its mortgage-backed securities).

To sum up, our hypothetical transaction makes the balance sheets "balance" for both

JP Morgan and the Fed. However, JP Morgan's balance sheet doesn't grow or shrink, just by trading some of its money for some bonds. In contrast, the Fed's balance sheet *shrinks* when it sells off assets, and effectively sucks reserves out of existence. There is a definite sense in which a *typical* Fed operation to tighten will reduce the total quantity of dollars in the banking system. This is the normal way that the Fed tightens, making reserves more scarce and hence leading to a higher interest rate that commercial banks must pay each other to borrow those reserves—what is the federal funds rate.

In order to warm the reader up to how things are different this cycle, let me first present what appears to be an alarming graph.

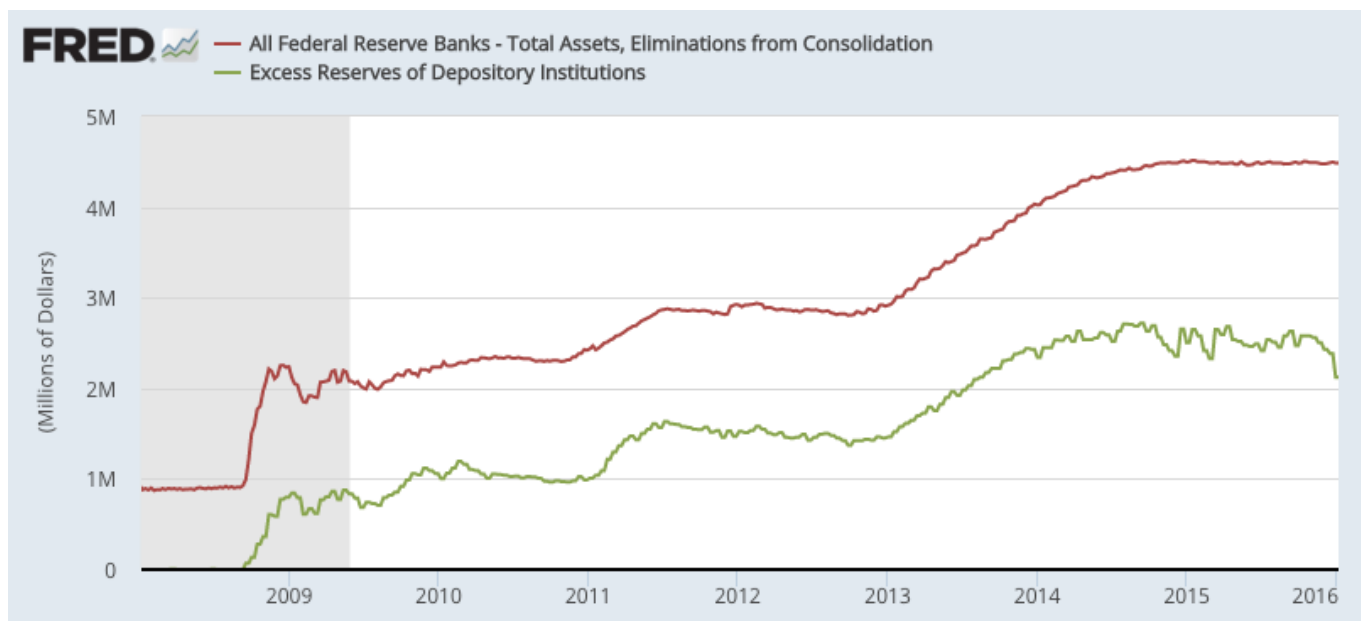


FIGURE 4. FED ASSETS VERSUS COMMERCIAL BANK EXCESS RESERVE BALANCES

Figure 5 shows that the drop in official reserve balances with the Fed (red line) corresponds pretty closely with the rise in the U.S. Treasury's account balance with the Fed (green line) and with "reverse repurchase agreements" ("reverse repos") held by the Fed (blue line).

For a full explanation, UC San Diego economist James Hamilton has an excellent post on his blog.³ But for our purposes, I can explain the essentials. The Fed wants to raise interest rates *without* selling off assets. So one main tool is that the Fed has increased the rate it pays for "interest on reserves" (IOR). Specifically, the Fed is now paying commercial banks 50 basis points (i.e. 0.5 percent) if they keep their reserves parked at the Fed.⁴ I like to summarize this by saying the Fed is paying banks to not make loans to their customers. With reserves of some \$2.4 trillion, that works out to an annual subsidy to the banks of \$12 billion.

However, that figure is a tad too high, because some of the reserve balances maintained with Federal Reserve banks are not eligible for IOR. For example, for legal reasons the Federal Home Loan Banks cannot be paid the 50 basis points that the regular commercial banks are now getting from the Fed. So for these institutions, the Fed is using a different trick.

First, two definitions from the financial world: A *repurchase agreement* ("repo") is a contract in which an entity sells an asset, but simultaneously agrees to buy it back at a specified future date and price. A *reverse repurchase agreement* ("reverse repo") is a contract in which an entity buys an asset, but simultaneously agrees to sell it back at a specified future date and price. (The two concepts go hand-in-hand: If Jim holds a repo with Fred, then Fred holds a reverse repo with Jim.)

Repos and reverse repos are really just vehicles for making collateralized loans with a specified repayment date and implicit interest rate.

Figure 1: repurchase agreement ownership structure



The Fed wants to begin raising rates (albeit modestly), but it doesn't want to sell off its Treasury or MBS holdings, for fear that this would cause a spike in Uncle Sam's borrowing costs and/or crash the housing sector.



Although they sound complicated, repos and reverse repos are really just vehicles for making collateralized loans with a specified repayment date and implicit interest rate. To see this, note that if for some reason the side of the transaction issuing the repo couldn't come up with the funds to buy back the asset, then the issuer of the reverse repo wouldn't get its money—plus the implicit interest charge—back but would at least have the asset.

The Fed uses both repos and reverse repos to temporarily add or drain reserves from the banking system, as this facilitates rapid (often overnight) injections and withdrawals, without having to permanently buy and sell its asset holdings each time the Fed wants to tinker with reserves.⁵ It is part of the broader Fed objective of separating its decisions about its own portfolio size and composition, and its decisions about short-term interest rates. In other words, since the fall of

2008—when the Fed introduced the policy of interest on reserves (IOR)—the Fed has wanted to separate its open-market purchases from its interest rate targets. Its growing use of repos and reverse repos should be seen in that context.

So, returning to our Figure 5, part of what's going on is that the Fed's December rate hike is occurring with a new policy of paying the Federal Home Loan Banks 25 basis points on their reserves, through issuing reverse repos. In other words, the Fed is borrowing reserves temporarily from these institutions, at an annualized interest rate of 0.25 percent. In terms of the Fed's accounting, its total assets are unchanged, but it these outside institutions have technically surrendered ownership of some of their reserves to the Fed in exchange for repos, which is why the official reserves number has fallen so rapidly recently.

Summary

What does it all mean? It boils down to this: In order to bail out the commercial and investment banks—at least the ones who were in good standing with DC officials—as well as greasing the wheels for the federal government to run trillion-dollar deficits, the Federal Reserve in late 2008 began buying trillions of dollars worth of Treasury debt and mortgage-backed securities (MBS). This flooded the banking system with trillions of dollars of reserves, and went hand in hand with a collapse of short-term interest rates to basically zero percent.

Now, the Fed wants to begin raising rates (albeit modestly), but it doesn't want to sell off its Treasury or MBS holdings, for fear that this would cause a spike in Uncle Sam's borrowing costs and/or crash the housing sector. So the Fed has increased the amount that it is paying commercial banks to keep their reserves with the Fed (rather than lending them out to customers), and—for those institutions that are not legally eligible for such a policy—the Fed is effectively paying

**We thus
have the
worst of
both worlds.**



to borrow the reserves itself. By adjusting the interest rate the Fed pays on such transactions, the Fed can move the floor on all interest rates up. No institution would lend to a private sector party at less than it can get from the Fed, since the Fed can create dollars at will and is thus the safest place to park or lend reserves.

We thus have the worst of both worlds. We still get the economic effects of “tighter monetary policy,” because the price of credit is rising as it would in a normal Fed tightening. Yet we don't get the benefit of a smaller Fed footprint and a return of assets to the private sector. Instead, the U.S. taxpayer is ultimately paying subsidies to lending institutions to induce them to charge more for loans, while the big banks and Treasury still benefit from the effective bailout they've been getting for years.



References

1. The long-term history of the Fed's target range for the fed funds rate is available at: <https://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html>. The more recent history is available at: <https://apps.newyorkfed.org/markets/autorates/fed%20funds>. Putting the two together shows that the target range of 0 to 25 basis points had been in place from the December 16, 2008 meeting through the December 16, 2015 meeting. The transcripts of those announcements are available at: <http://www.federalreserve.gov/newsevents/press/monetary/20081216b.htm> and <http://www.federalreserve.gov/newsevents/press/monetary/20151216a.htm>, respectively.
2. The post was here: <http://consultingbyrpm.com/blog/2016/01/federal-reserve-banks-total-assets-vs.-reserve-balances.html>.
3. James Hamilton's post explaining how the Fed is raising rates: <http://econbrowser.com/archives/2015/12/managing-the-feds-balance-sheet>.
4. Although it was literally not mentioned in the Fed's December policy announcement, the information on the new IOR policy is available at: <http://www.federalreserve.gov/monetarypolicy/reqresbalances.htm>. From October 2008 through December 16, 2015, the IOR rate had been 25 basis points.
5. The Fed explains its use of repos and reverse repos here: <https://www.newyorkfed.org/aboutthefed/fedpoint/fed04.html>.



**Positive Thinking,
Positive Action—**

Positive Cash Flow!

by L. Carlos Lara

AS THIS *LMR* ISSUE GOES TO print it is the latter part of January 2016. The New Year is barely out of the gate so many of us are still reviewing our *to do* lists for the coming twelve months. Aside from the standard fare of resolutions to lose weight, get healthy and fit, our focus invariably turns to our most important area of concern—our financial affairs. This central point causes all of us to reflect upon the state of our economy because there is an inseparable umbilical cord between it and us. Unfortunately, this is where the biggest source of people's anxiety rests.



Once you pierce through the misinformation in mainstream news, the facade of a healthy economy quickly fades.

As most of us already know, the year has started off badly. Once you pierce through the misinformation in mainstream news, the facade of a healthy economy quickly fades. Quite frankly, today there are no real positive economic indicators anywhere. Even the stock market, traditionally known as the most sensitive barometer of people's feelings about the economy, has already this year fallen below 500 points in a day on two separate occasions!!

Unlike the financial crisis of 2008 where everyone was caught completely off guard when the financial collapse occurred, today the most prudent of our populace knows that something ominous is definitely coming and is literally just waiting for it to happen. The fact that this is an election year does abso-

lutely nothing to soothe this growing angst.

There are those, however, who believe that times have drastically changed for the better. There is a widespread view that it's a whole new ball game now. We have all learned valuable lessons from our past mistakes, it is argued, and will not repeat them again. With new regulations now in place, our economy's leaders, for the betterment of all society, have dramatically altered things. We're smarter now. The old rules of valuation no longer apply and central planners can easily swoop back in and re-prop the economy up before it slips into another bad recession—so why worry? Unfortunately, this fallacy is a known syndrome that is as old as the denarius. People historically are known to have short memories, which is one

reason why politicians, financial promoters, and central bankers can easily convince the naïve public into thinking that this time it's different.

We must come to recognize that a lot of squandering of the economy's assets by a select few has always occurred while the taxpayer was not paying attention. This usually happens during the rise of an artificial-

to be continuously rolled over or refinanced. Eventually these economies collapse. These were the culminating results shown by authors Reinhart & Rogoff, who documented eight centuries of world financial follies in their classic book— *This Time Is Different*.¹

The ability of governments and investors to delude themselves into stretching the limits has remained constant worldwide and is the

real lesson of history. In effect what these authors assert is that highly indebted households, corporations, banks, and governments can seem to be rocking along just fine for extended periods of time when BOOM!—confidence collapses, credit gets cut-off, lenders vanish, and a cash-flow crisis ensues. What happens next is painful to endure. It's no wonder that those of us who recognize this as nothing but the truth are watchful and on high alert as this New Year begins to unfold.



Highly leveraged economies can actually sustain this unchecked debt for prolonged periods of time so long as confidence holds up.

ly induced boom or in the aftermath of its bust. In fact, heavy borrowing usually occurs during the times of the success of the credit-fueled bubbles. Surprisingly, highly leveraged economies can actually sustain this unchecked debt for prolonged periods of time so long as confidence holds up. But confidence is fickle. This is especially true in cases where large short-term debts collateralized by relatively illiquid assets need

Positive Thinking

Given this grim outlook it is undoubtedly difficult for any of us to muster up any kind of positive thinking in order to manage our economic affairs in this new year, much less in our everyday lives. Yet this one human essential is absolutely necessary for making positive things happen in our world. After all, success in life is trumpeted as being de-

terminated by our attitude and that attitude needs to be positive. Attitude, it is proposed, is even more important than I.Q.

But to know exactly what this means and how it is actually put into practice in reality is akin to discovering the meaning of life. Deep thinkers will quickly recognize that uncovering this mystery is no easy task. Furthermore, there is no such thing as purchasing this life secret from anyone for a price, even though they may claim to have it for sale. I would contend that its hidden meaning cannot be fully grasped without first coming to grips with personal failure and the suffering that comes with it. The truth is that problems are a reality of this world and at times can make life extremely difficult for many of us. Indeed, failure may need to be experienced several times in order for an individual to understand what it is like to be completely dispirited. The real deciding factor in positive thinking and success in life is more about how one ultimately handles

failure and its painful consequences including *fear*.

Fear is paralyzing. But fearless people we notice are never idle. They seize the moment knowing full well it may be their last. More precisely, they are courageous even in the face of fear. They are keen to understand that many things in life are simply beyond their human power. They eventually conclude that in the final analysis they are not masters of their soul or their destiny. They come to understand that the Almighty is ultimately the controlling factor in human affairs and with that they are content. The result of this mental conversion is *humility*. This is beautifully summarized in this famous petition written by an anonymous author:

“God, grant me the serenity to accept the things I cannot change, the courage to change the things I can, and the wisdom to know the difference.”²
—*The Serenity Prayer*



Positive thinkers, the type I am referencing here, are doers, or better yet—they are problem solvers.

In other words, these courageous gentle giants know that personal willpower has its limits. No amount of personal affirmations or motivational training will ever change that fact, except temporarily and usually while the going is easy. The lesson here is that we must be wary of our own desires for wealth and power for they are intoxicating aspirations that can blind us to the truth and cause us to be easily led astray by the innumerable charlatans in the world.

Positive thinkers, the type I am referencing here, are doers, or better yet—they are *problem solvers* filled with passion and relentless conviction. They are empowered people in pursuit of excellence in an imperfect world. They see a problem clearly and set out to solve it. No matter what the obstacle may be, they don't stay helpless. Positive thinkers take *action*.

Positive Action

The best way to overcome paralysis is to take action. Taking action moves our minds off our fears and turns our depressed emotions into positive constructive energy. This, of course, is easier said than done. Mises himself declared:

“Action is a display of potency and control that are limited. It is a manifestation of man who is restrained by the circumscribed powers of his mind, the physiological nature of his body, the vi-

cissitudes of his environment, and the scarcity of external factors on which his welfare depends.”³
— *Human Action*

I once sunk into an emotional abyss, which I thought had no exit. But even in the depths of my own despair merely walking lifted my spirits. I gained confidence by seeing one



These courageous gentle giants know that personal willpower has its limits.

foot placed in front of the other even though nothing else in my life seemed to budge for years on end. Eventually I was able to run—I don't mean just physically, but in the sense that taking positive actions eventually permeated my entire being and created enthusiasm. Actions became the precursors to achieving results and, if it is not too presumptuous to say, I actually came to expect positive results from these exertions. However, these actions are never aimed at anyone's defeat or loss, but rather as a striving for a win-win improvement of present

conditions. Of course, I don't perform these perfectly, but they serve to empower me and they are better than the present alternative. Here again, Mises provides a way to understand the importance of this:

*"The vigorous man industriously striving for the improvement of his conditions acts neither more or less than the lethargic man who sluggishly takes things as they come. For to do nothing and to be idle are also action and they too determine the course of events."*⁴
—*Human Action*



Yet having a positive cash flow is, in one very important sense, the end result of our positive thinking and positive action.

Conclusion—Positive Cash Flow

So we come full circle and end these thoughts with a theme that addresses our most important area of concern—our financial affairs and the economy. Here we refer to *positive* cash flow. It almost seems out of

context relative to what we have been discussing. Yet having a *positive cash flow* is, in one very important sense, the end result of our positive thinking and positive action to solve an enormous problem in an economy that has gone terrible awry. It may seem strange to many, but there is no safer ground for our households or businesses to stand upon at times such as these than on an infrastructure that is cash flow positive. What this represents is a debt free or low debt enterprise with maximum liquidity. If debt should exist it must be positioned in such a way that we can come out from under it without going bankrupt. The picture we should all see is cash.

But that cash should not be stored in commercial banks. This is the natural inclination. But in light of new regulations, namely the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, signed into federal law by President Barack Obama on July 21, 2010, all financial institutions and specifically commercial banks with assets over \$50 billion in assets are subject to strict federal oversight including statutory

bail-ins if they should become insolvent in another systemic risk crisis such as what we had in 2008. (SEE: *LMR May 2014*, "Bank Deposits Are Risky—Now More Than Ever!" and *LMR February 2015*, "From Bail-Outs to Bail-Ins, Understanding The Dodd-Frank Act.")



The definitive product should be a dividend paying Whole-Life policy, designed according to the stipulations of Nelson Nash's IBC.

In light of this situation the absolute safest place to warehouse our cash is in the insurance sector. Specifically, it should be housed inside a mutual company, or mutual holding company, where policyholders are the owners. The definitive product should be a dividend paying Whole-Life policy, designed according to the stipulations of Nelson Nash's IBC. This provides the proper infrastructure to practice a form of *privatized* cash flow management that is far superior to commercial banking, and due to our present economic circumstances, the most secure. Millions of Americans, in fact many of the most financial competent in our country simply do not know about this cash flow management alternative. **SEE:** www.infinitebanking.org

In my *LMR* article entitled "IBC for Business Owners" dated October 2012, I reported that businesses were sitting on an enormous amount of cash. In fact, they were holding more cash (broadly defined to include MMMFs) than has been held since World War II. Even if we focus on cash in commercial banks proper, they are holding more as a share of the economy than at any time since the mid-1960s. A whopping \$1.4 trillion worth of cash to be exact! The question in 2012 was why?

If you are self-employed, or are a business owner, you can probably answer this inquiry rather quickly given a moment to consider it. The answer is simple. In times of great financial uncertainty business owners intuitively know that *first*—***you need cash to maneuver*** and *second*—***you need to be able to access that cash immediately when you need it.*** Maintaining a liquid position in an economic environment such as what we have today is simply practical common sense. Cash and positive cash flow are more important factors than having a strong balance sheet, especially if that balance sheet is weighed down with illiquid assets.

Why Are Corporations Holding So Much Cash?

The Federal Reserve Bank of St. Louis, on its website and in an article by the same title, gives us two main reasons why firms are finding it beneficial to hold cash at this time. The first has to do with the repatriation of taxes. For multinational firms profits generated abroad are not taxed in the U.S. until they are repatriated, hence substantial funds are being held abroad in the form of cash.

The second reason given is because of precautionary motives—uncertainty and credit constraints. Firms facing this set of circumstances find it beneficial to pile up significant amounts of cash as a cushion to weather

ed to the aftermath of the financial crisis.”⁵

Ironically, the leading news headline of this New Year that makes us ponder the most about the state of our economy is not



Cash and positive cash flow are more important factors than having a strong balance sheet, especially if that balance sheet is weighed down with illiquid assets.

about the economic slowing down of China, or the extremely low price of crude oil, or even the roller coaster swings of the stock market—although all of these should be taken seriously. It is the fact that corporations have increased their holding of cash by another \$500 Billion! According to a very recent *New York Times* article, “Why Are Corporations Hoarding Trillions?” dated January 20, 2016, that number is now up to \$1.9 trillion!⁶ Once again, we are prompted to ask—why? Is this a good thing or bad?

hard times. This, the Fed proves in several graphs that demonstrate a rising trend in cash hoarding by non financial corporations, “which started in 2008-2009 and is connect-

There is no question that something big is lurking in the wings. Our government and central bank officials know it. CEOs of corporations know it. Everybody is getting ready. Are you ready for it?



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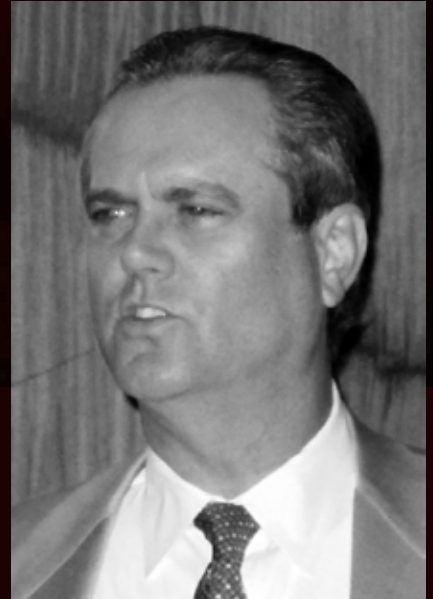
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OIL PRICES AND THE BUSINESS CYCLE

A large, dark silhouette of an oil pumpjack dominates the left and center of the image. It is set against a vibrant, warm-toned sunset sky. The sun is a bright, glowing orb on the right side of the horizon, casting a long, horizontal glow across the sky. The overall color palette is dominated by oranges, yellows, and deep reds, creating a dramatic and industrial atmosphere.

Interview With
Robert L. Bradley, Jr.

Robert L. Bradley Jr. is the founder and chief executive officer of the Institute for Energy Research (IER), a 501(c)3 educational foundation with offices in Houston, Texas, and Washington, D.C. *[DISCLOSURE from eds.: Robert P. Murphy is currently the Senior Economist for IER.]* He is an adjunct scholar of the Cato Institute and of the Competitive Enterprise Institute, a visiting fellow of the Institute of Economic Affairs in London.



Bradley, who holds a BA and MA in economics and a PhD in political economy, received the Julian L. Simon Memorial Award in 2002 for his work on free market approaches to energy sustainability. Bradley is author, most recently, of *Edison to Enron: Energy Markets and Political Strategies* (Scrivener Publishing and John Wiley & Sons). His blog www.masterresource.org is a cutting-edge free-market energy site.

LARA-MURPHY REPORT: How did you discover Austrian economics?

ROBERT L. BRADLEY, JR.: I read an Ayn Rand novel, *The Fountainhead*, in high school. I loved the book and went on to read Rand's edited book of essays, *Capitalism: The Unknown Ideal*, which was basically an introduction to free-market economics. From there I discovered Henry Hazlitt and started hearing about Ludwig von Mises.

Early on at Rollins College, I read an obituary by Robert Bidinotto in an Objectivist magazine. "Von Mises: A Final Salute" in *Unbound!*, published by Individuals for a Rational Society, was a huge eye-opener. I started reading von Mises and was captivated by his logic and clarity.

And guess what? In my sophomore year at Rollins, stagflation blew up the Phillips

Curve and put the whole Keynesian economics paradigm on trial. The Austrians had the explanation, and my raised hand in class got some of the professors to consider Mises, Rothbard, and Hayek.

LMR: We interviewed originally back in March 2014, but we wanted to get you back since you are both an Austrian economist and an expert on oil markets. To start things off, can you explain what the exact situation is regarding oil prices? How big a deal is what we're seeing, from a historical perspective?

RB: Recent developments in the oil and gas market, coming on top of a lot of change last year, remind me of a von Mises quotation. Near the end of *Theory and History*, he stated: "The outstanding fact of history is

that it is a succession of events that nobody anticipated before they occurred.” I certainly did not, and I am a resource optimist.

Even Julian Simon, if he were alive, would surely be surprised, although he predicted that oil would become plentiful again when no one else was saying so in the early 1980s. Oil peaked then at just over \$31 per barrel, which in today’s dollars would be about \$83 per barrel.

Historically, as you Bob know, having put together the inflation-adjusted spreadsheet,

terms of: what will get Americans to spend more? (His tentative answer is that moderate falls are good for the economy, because it redistributes money from rich oil tycoons to working folk, but large drops in the price of oil are bad for the economy, because it makes some firms go under.) What do you say as an Austrian?

RB: Falling commodity prices in general are a good thing in a free market because, as Mises emphasized, the sole end of production is consumption. Consumption first, production second.

“OIL AND NATURAL GAS PRICES TODAY ARE BELOW THEIR POST-WORLD WAR II AVERAGE, SOME 65 YEARS. I DO NOT THINK THAT MEANS THAT PRICES TODAY ARE ‘TOO LOW’—ONLY THE SWEEP OF HISTORY CAN ANSWER THAT.”

oil and natural gas prices today are below their post-World War II average, some 65 years. I do not think that means that prices today are ‘too low’—only the sweep of history can answer that.

Also the U.S. is a net importer of both oil and natural gas, which means we consume more than we produce. So provincially speaking, the U.S. gains more than it loses

LMR: Economists are now arguing about whether falling oil prices are a good thing or bad thing for the United States, but (of course) they typically adopt a Keynesian framework. For example, Paul Krugman analyzes the situation in



from well-to-pump or well-to-burner-tip price drops.

The other part of the equation that has not gotten as much attention is the boom in refining and petrochemicals that has occurred from lower feedstock (crude oil and natural gas) costs. Here in Houston, the east side is in a boom and the west side is languishing because of the two energy worlds. I'll let you guess which side of Houston is related to downstream, and which to upstream.



“THE OTHER PART OF THE EQUATION THAT HAS NOT GOTTEN AS MUCH ATTENTION IS THE BOOM IN REFINING AND PETROCHEMICALS THAT HAS OCCURRED FROM LOWER FEEDSTOCK (CRUDE OIL AND NATURAL GAS) COSTS.”

LMR: We know that certain analysts—such as David Stockman—for some time have been warning that the Fed’s cheap credit policy was (at least partially) fueling the fracking boom, and that a lot of those operations were vulnerable. Do you think that is a big part of what we’re seeing—as opposed to, say, blaming slowing growth in China?

RB: There are two concerns I have about the price roller coaster, which creates a mini-business cycle, if you will. One, artificially low interest rates encouraged debt drilling—and those companies and their banks are in big trouble now. And the oil they produced is contributing to the price doldrums that the better financed producers now have to

endure.

Second, government policies to restrict demand because oil and gas are thought to be environmentally bad, even at the given level of regulation, have exacerbated the cycle. Low oil prices, in other words, are generating less demand than would occur in a truly free market where, say, federal fuel economy standards were absent. Virtually all energy appliances are subject to forced conservation standards, creating a problem for the old adage that “low prices are the cure for low prices.”

Also remember the ‘seen’ versus ‘not seen.’ We witness and can compute the resource losses in the upstream oil and gas industry.



“WE WITNESS AND CAN COMPUTE THE RESOURCE LOSSES IN THE UPSTREAM OIL AND GAS INDUSTRY. WE CANNOT SEE THE THOUSAND SMALL DEMAND INCREASES FOR ALL OF THE THINGS THAT GET PURCHASED FROM CONSUMERS PAYING LESS FOR ENERGY.”

We cannot see the thousand small demand increases for all of the things that get purchased from consumers paying less for energy. There could be increased savings and investment too, creating economic activity in those directions.

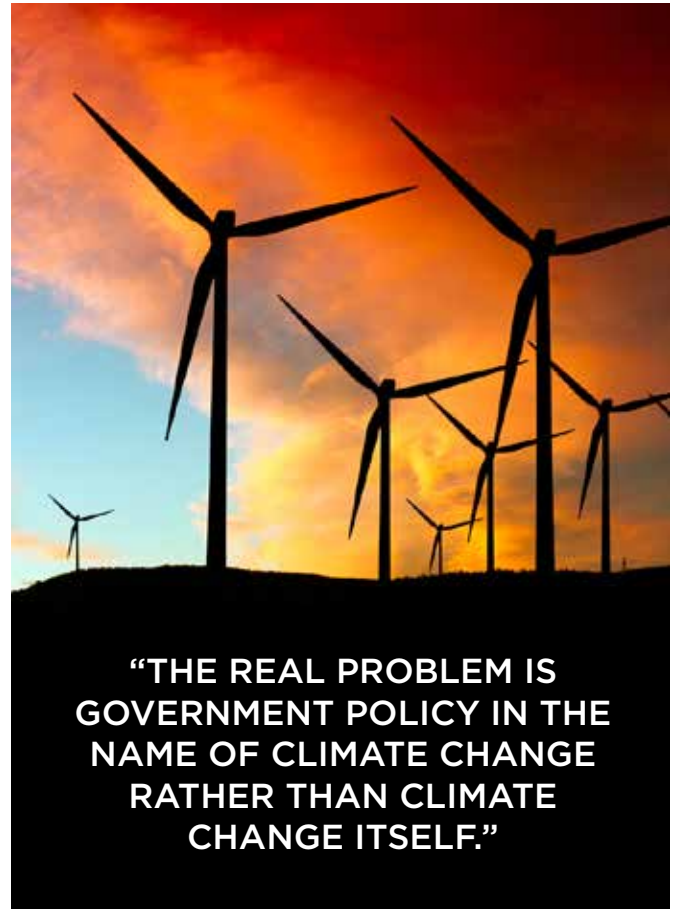
problem, much less a potential catastrophe, from higher atmospheric concentrations of CO₂. And as you know, Bob, the real problem is government policy in the name of climate change rather than climate change itself.



LMR: Finally, a lot of progressives have been applauding the recent Paris deal, in which many nations made unilateral pledges to reduce their greenhouse gas emissions. What’s your take on the Paris conference, and the issue of climate change more generally?

RB: It seems to be a moral victory for the alarmists to say that ‘the world agrees’ to a role for government to control and plan the energy economy, not to mention land-use changes tied to the carbon cycle. Climate intervention is the new central planning for governments that want or need to do something with the intellectual case for central planning having lost favor.

But climate and energy reality point in a different direction. There is not much of a



“THE REAL PROBLEM IS GOVERNMENT POLICY IN THE NAME OF CLIMATE CHANGE RATHER THAN CLIMATE CHANGE ITSELF.”



EVENTS & ENGAGEMENTS

JANUARY 30, 2016
HOUSTON, TX

Murphy presents on Austrian Economics at Mises Circle with Ron Paul, Lew Rockwell, and Jeff Deist

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FEBRUARY 13, 2016
BIRMINGHAM, AL

Nelson Nash, Lara, and Murphy present at IBC Workshop

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<http://infinitebanking.org/the-ibc-workshop/>

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FEBRUARY 27, 2016
WASHINGTON DC

Murphy presents on Rothbard and Mises at International Students for Liberty Conference

SOME EVENTS MAY BE CLOSED TO GENERAL PUBLIC.
FOR MORE INFORMATION: LMREVENTS@USATRUSTONLINE.COM

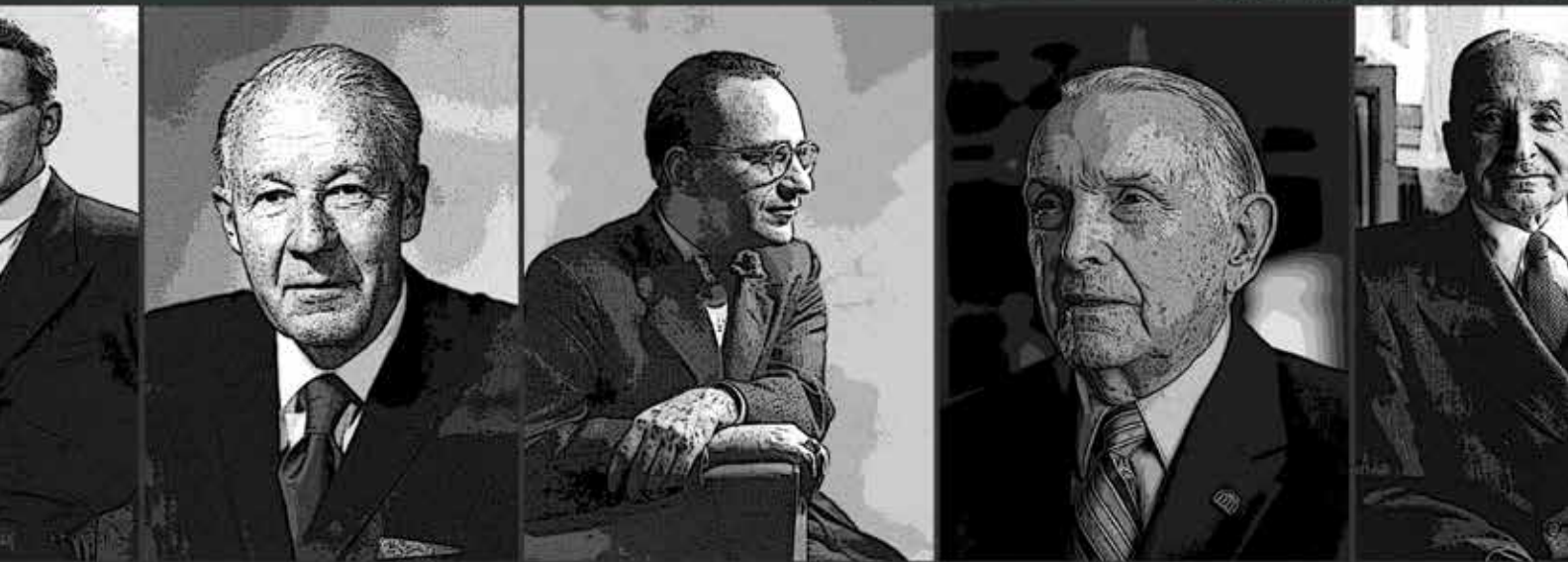
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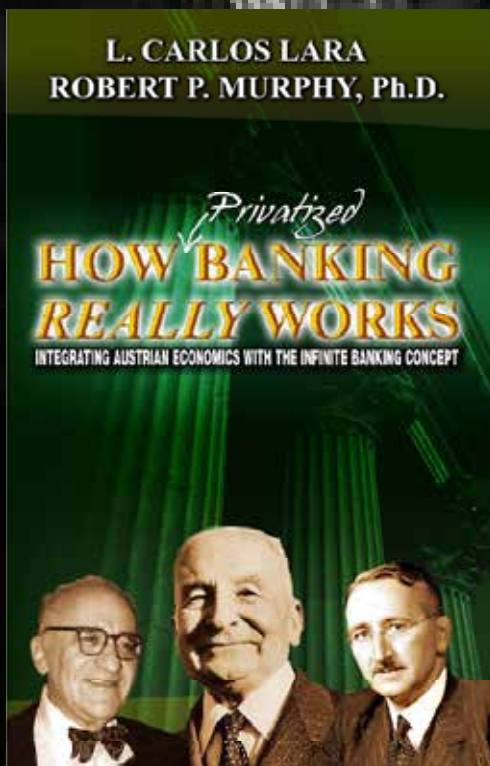
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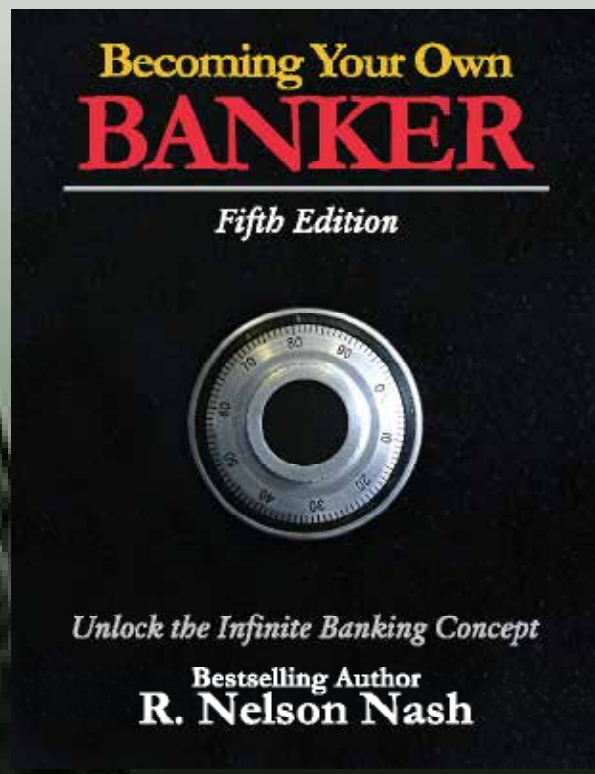


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