INTRODUCTION

MOST PEOPLE share two beliefs about the economy:

- *First,* it's unpredictable.
- *Second,* if you want to understand it, you have to rely on a trained economist.

This book offers a different proposition:

- *First,* although forecasting is difficult, certain methods can help you anticipate developments such as recessions, depressions, and crises.
- *Second,* to have any success, you need to reject standard theory and be wary of trained economists.

I'll describe an analytical approach that you won't find in a textbook or learn in a classroom, and then I'll back it with research and invite you to test it against your own thinking. I'll also explain how the approach corrects for the biggest blunders of mainstream economics. For this, we'll need to pick apart the causes of those blunders, and that's where the book begins. My premise is that before we look at the practical side of economics—the stuff we really need to know—we should first consider where the academics went wrong.

I won't criticize economic theory blindly or indiscriminately. For starters, I'll critique only the macroeconomics that emerged in the mid-twentieth century, not microeconomics. If you liked micro-oriented titles such as *Freakonomics* or *The Undercover Economist,* there's almost no overlap with the topics covered here. And within macro, I'll argue that you can find

valuable research if you know where to look. It's just that the best work is from a minority who refuse to abide by standard practices. Much of the rest of the work is by abstract theorists and mathematicians who create models bearing little resemblance to real life.

To use an expression that was a favorite of an old colleague of mine, academic economics is full of smart people doing stupid things. Their models become dogma for long periods of time, until they eventually end in tears. Not economists' tears but the tears of those who suffer the consequences of a lousy economy.

Theories and Consequences

Let's look at a few of the mishaps that have occurred during my lifetime:

- The Great Inflation of the 1970s
- Stop–go monetary policies and severe recessions in the early 1980s
- The last decade's debt and housing bubbles

Faulty theories didn't single-handedly trigger these unwelcome events, but they were certainly part of the plot:

- The Great Inflation shattered leading theories of the 1960s, which held that inflation couldn't become a problem unless the unemployment rate were to fall to about 4% or lower.
- The 1980s recessions were a natural consequence of the Great Inflation, but they also featured a hopeful theory that took over much of the profession before it was discredited. Economists argued that our central bank should pursue only one policy objective—a constant growth rate for the nation's M2 money supply—even though M2 is naturally volatile and highly flawed.
- The debt and housing bubbles were dismissed or downplayed by many big-shot economists. Theoretical models deceived those economists, who thought that borrowers and lenders couldn't possibly act in a way that could threaten stability.

If we could go back fifty years and ask economists about the odds of these developments, they'd say slim to none. The "New Economics" of the 1960s held that policy levers were so powerful that they could eliminate the business cycle. Paul Volcker, who worked in the Treasury Department before becoming Federal Reserve chairman in 1979, described the mood

in the 1960s as "a feeling of exuberance in the economics profession, because it really thought it had the business of the cycle of boom-and-bust licked." Another policy maker, Arthur Okun, wrote, "Recessions are now generally considered fundamentally preventable, like airplane crashes and unlike hurricanes." In hindsight, such comments were classic signs that our luck was about to turn. They were followed by four recessions in the 1970s and early 1980s, including the unusually severe recessions of 1973–75 and 1981–82. They were also followed by the nation's highest-ever peacetime price inflation—the Great Inflation.

In the early 2000s, the profession was once again buzzing about the economy's stability. Ben Bernanke shared his thoughts in 2004, two years before becoming Fed chairman. He delivered a speech on the long expansions and mild recessions of the previous two decades, dubbed the Great Moderation. His conclusion? The long period of stability is best explained by effective monetary policies. "This conclusion on my part makes me optimistic for the future," he said. Nobel laureate Robert Lucas was even more optimistic, telling his peers in 2003 that economic theory had succeeded so completely that the game was basically over. He said that the "central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades."

We can surely conclude that economists' supreme confidence, during the 1960s and again in the early 2000s, was misguided. And it's not as though they've merely suffered a fifty-year run of bad luck. A deeper look at history points to a growing belief that economists could conquer the business cycle during the 1920s, when the Fed first tried stabilization policies. The National Bureau of Economic Research (NBER) wrote that the Fed's approach should "assist in flattening out the fluctuations of business and bringing about a more even prosperity." True to the normal pattern of hubris leading to disaster, the NBER made this claim in 1929, on the eve of the Great Depression.

Don't Worry, Be Happy

If the profession's performance were repeated in, say, medicine, we'd have a major "breakthrough" in medical procedures every few decades that would eventually maim or kill many of the patients involved. Or, to put a lighter spin on recurring policy failures, the unusually forthright International Monetary Fund (IMF) economist Michael Mussa was fond of saying that

his favorite approach was prayer: "It was not demonstrably less effective than the other instruments and it had none of the adverse side effects."

A common thread running through various failed theories is that economists manage to persuade people that there's nothing to worry about. They rely on a simplistic view of the world in which real-life problems don't exist. They've argued that

- neither house prices nor mortgage debt can decline on a nationwide basis;
- even when debt goes sour, it doesn't matter to the broad economy;
- huge fiscal and trade deficits are nothing to be concerned about; and
- we shouldn't worry about massive financial derivatives exposures, either.

The profession has made a farce of the words of another former Fed chairman, William Martin, who said that the central bank's job is to "take away the punch bowl just when the party gets going." Many economists, including a few of Martin's successors at the Fed, take the opposite approach. They encourage partiers to "drink up! We've cured the hangover."

Forecasting Flops

In perhaps the biggest irony, plenty of laypeople can see the flaws in mainstream theory. Yet economists use their credentials to drown out more logical voices. Harvard University's Dani Rodrik concedes that his peers "are clannish, drawing a big distinction between who's in and who's out (i.e. card-carrying members of the profession versus the rest). As with all possessors of specialized knowledge, they tend to get arrogant when outsiders encroach upon their field."

As I see it, that's all the more reason to encroach. I don't mean storming the ivory tower or expecting a plush policy position but rather asking yourself if you really benefit from the advice dished out by economists. Business economists, especially, might influence your most important decisions. They face different incentives than academics, but many of them perform just as poorly. As a group, they're routinely blindsided by major events. Not only does the consensus outlook (the average of all forecasts) nearly always fail to predict recessions but it typically fails to acknowledge recessions *after* they've begun. Forecasters have again and again proven Mark Twain's maxim that the majority is always wrong.

If you follow economic forecasts, you'll surely remember some duds. Two stand out for me. They're memorable partly because of their enormity and also because the firms that made them have prestigious and costly research teams. Here are the details.

Example 1: Investment Bank Calls for a New Era of Prosperity

The first forecasting dud was a lengthy report that Morgan Stanley published in January 2007 and confidently titled *MacroVision*. It was written by the firm's most senior strategists and revealed the conclusions of an off-site forecasting powwow. They called it a sort of State of the Union for the global economy. The document began with a declaration that the experts had never before seen so little risk. Never before had this group been as strongly and unanimously bullish. On page after page, the authors raved about the surge of "global liquidity" that they expected to be a long-lasting source of prosperity. In repeated attempts to define "liquidity" and describe its effects, they failed to recognize that the developments they were discussing were neither favorable nor sustainable. Those developments were the markings of the largest debt bubble the world had ever seen. And the bubble was just starting to deflate. At that very time, bond investors were puzzling over the shockingly poor performance of subprime mortgage securities. Housing investment had already peaked twelve months earlier. In other words, just as the storm of the century was drifting into sight, *MacroVision* was calling for clear skies as far as the eye could see.

Example 2: Research Firm Mocks Recession Forecasters—in the Middle of a Recession

In the following year, GaveKal Research (an economics and market research firm with an impressive client list of hedge funds, banks, and other financial institutions) issued a similar dud. This firm was bullish in 2008 and openly scornful of anyone who detected a recession. It published an article titled "The Recession That Never Was" and stated its case with the evenhandedness of Rush Limbaugh and the modesty of Charlie Sheen. While comparing pessimistic forecasters to Jehovah's Witness evangelists, the article's authors outlined the supposed mathematical impossibility of a recession. Their document was published on August 6, 2008. They repeated their optimistic message for several weeks thereafter, until the following month's financial meltdown. In other words, this

firm forcefully defended its clear-skies forecast even after the storm had moved directly overhead.

No More Lucy

What I'm trying to show is that throwing money at economic research hasn't worked. The private sector's most highly paid economists aren't dependable, nor are academics. Most of the time, relying on the so-called experts fails—which brings me back to my ridiculous-sounding proposition. That is, you can do better. I'll argue that the smoothest talking heads on Wall Street and most credentialed prizewinners at our best universities are either ill trained or not incentivized to foresee risks. You can depend on them if you like—just as Charlie Brown trusts Lucy to hold the football steady for his next kick. But there may be a better way. I believe that you can gain a better understanding of economic risks by developing your own outlook. Or, if you continue to use professional advisors, you can become more adept at evaluating their research, separating good advice from bad.

Whether you buy into my argument is, of course, for you to decide. You should know first that I'm an outsider to the economics profession. I'm mostly self-taught, which in my opinion gives me an edge on trained economists. I'll explain why as I describe my approach. For now, I'll tell you that I've studied economic theory, economic history, and the history of economic thought much more than the average outsider. My breadth of knowledge, in particular, is fairly extensive. It reaches theories and methods that many insiders neglect, because they rely wholly on the mainstream methods that I'll challenge in the book's early chapters.

Professionally, I've spent nearly three decades comparing economic theories to the realities of the asset management field. Asset management research and day-to-day decision making help build a perspective on how the economy really works. They also tie into forecasting. I predicted the recession in 2008, the tepid recovery in 2009, the low interest rates and inflation that followed, and related peaks and troughs of the credit cycle. During the last decade's mortgage mania, I blocked a strong push to stuff my firm's mutual funds with a "cutting-edge" strategy consisting mostly of toxic mortgages. Although my stand was about as popular as Brussels sprouts on a dessert table, it prevented certain catastrophe. This and other similar episodes sum up my approach. I question everything and don't mind being contrarian if that's where the answers lead.

I decided long ago that my proposition about tuning out the "experts" isn't so ridiculous after all, and this book is partly about sharing the path to that conclusion.

I'll present my methods, rationale, and evidence in four steps, each of which embeds a list:

1. **Three sources of volatility.** After examining the problems with mainstream theory, we explore other ways of thinking. We take a close look at three big sources of volatility—credit cycles, human nature, and the business environment—with the help of a handful of rebel economists. We then replace the mainstream paradigm with a new paradigm, although one that harkens back to established thinking before the mainstreamers expunged all ideas not expressed as mathematical equations.
2. **Six cycles.** We look beyond the business cycle to six separate but related cycles, each describing a distinct part of the economy. We then consolidate the cycles into a diagram that further develops our unconventional (but realistic) paradigm.
3. **Ten rules.** We examine my rules of economic analysis, a few of which may seem obvious, whereas others may be tough to believe. Either way, I explain my reasoning and corroborate with data so that you can judge the rules for yourself. For the reader who doesn't mind numerical analysis, I also show that the rules lead to an effective recession indicator.
4. **Eight levels of risk.** We adopt a new approach to sizing up the imbalances that are sure to threaten the economy in the future. As in the other steps, I'm not touting a magic formula to apply blindly to all situations. More realistically, I'm recommending a risk hierarchy for establishing the severity of emerging problems. I also share surprising research on what that hierarchy tells us today.

For those who don't know much about economics, I introduce key terms and concepts within each of the four steps. Together, the steps break down the ideas I believe are the most important for you to consider. They flow from general (high-level concepts) to specific (methods and analysis). To preserve that order, I recommend reading the first two parts of the book in sequence, which takes you midway through my rules of analysis. Parts 3 and 4 branch off in different directions, covering business cycles and economic imbalances as separate (though related) topics.

Breaking through the Din

After contesting mainstream methods in the first chapter, I'll then continue to contrast my methods to the mainstream throughout the book. Truth be told, one reason for making such comparisons is that I'd like to convince you that the case for rejecting orthodox theory is overwhelming. But I also have a second reason, which presumes that you're well exposed to economic news and commentary. Essentially, my heterodox observations have to compete with media coverage that orthodox theory dominates. If I didn't point out where my message differs, the regular punditry would eventually push anything you read here toward that part of your brain that houses seventh-grade geometry theorems.

In other words, I'll try to put a voice in your head that reminds you to consider heterodox ideas before buying in to the orthodox story. You'll have a better understanding of the major characteristics of both. When you hear statements that are steeped in dubious assumptions but presented as facts, you'll call foul. In some cases, you'll be able to recognize faulty commentary and then replace it with methods that I'm recommending. In fact, that's a key goal of the book, which I'll describe in more detail in a moment.

Where I Stand on the Origins of Bad Economics

First, I'll separate my criticisms of mainstream economics from a few that I won't make. (Better that you don't misread my intentions right from the start.) Critics lob as many types of missiles at economists as there are in America's combined forces. Here are two frequently fired missiles that I won't endorse:

- Many commentators would like you to believe that economics is a nefarious plot, that it's overrun by free-market ideologues conspiring to push a conservative agenda. These commentators claim that conservative thinking is the root of all our problems. At best, their story is imbalanced. At worst, it assigns motives and meanings that don't match those of the original actors, thereby garbling the discussion and misrepresenting the history of economic thought. For example, pundits connect a long line of economists to the fanatical belief that private markets never fail. More careful analysis, though, shows that such fanaticism is unusual. More typically, conservative (and moderate) scholars believe that private

enterprise is imperfect, but so is the public sector, implying that the strengths and weaknesses of each should be carefully weighed. In those places where I can't avoid politically charged conclusions, I'll aim to exercise such care. I'll discuss the ideological origins of mainstream theory without pinning the "blame" on an exaggerated notion of conservatism. (That said, I've yet to discover the secret to building an all-denominations church—you, free-thinking reader, will surely find something, somewhere in this book, that fails to match your beliefs.)

- Commentators are also fond of slamming an idea called the *efficient markets hypothesis* (EMH), which suggests that investment securities are always priced correctly with respect to fundamentals. I won't pile any more contempt on the EMH, for two reasons. First, it belongs to the realm of investment portfolio theory, whereas the foundational models that macroeconomists use abstract away from investment portfolios. In fact, macroeconomic models consider neither investment portfolios nor liabilities, because they don't include balance sheets at all. Second, the popularity of the EMH has waned over time, such that it's no longer in vogue to claim full market efficiency. On the contrary, its primary use today is to provide a reference point for examining *inefficiencies.*

My critique of mainstream economics targets the macroeconomic models that are thought to explain economy-wide results like output, employment, and inflation. The earliest was introduced in the late 1930s and called the *IS–LM model.* It became the primary building block for *Keynesian* theory, which revolutionized economics in the mid-twentieth century. Keynesians believe that government intervention can diminish or even eliminate the business cycle. They rely on models, such as the IS–LM, to guide their suggested interventions. But most Keynesians moved on to a second generation of models, dubbed *New Keynesian,* after the original models performed poorly in the 1970s and 1980s. Meanwhile, non-Keynesian mainstreamers use *New Classical* models, which share the same basic design with the New Keynesian models. In part 1, I'll sketch the broad contours of that design.

Just as you can think of the EMH as a reference point, you can think of macroeconomic models in the same way. But the influence of macroeconomic modeling is far more sweeping. It determines the way that economics is taught, researched, and even spoken. It also shapes how

economists see the future. Some academics dispute that last statement. They insist their craft has nothing to do with predicting the future. They swear they don't make forecasts. Don't be fooled. Economists use models to evaluate how certain occurrences work their way through the economy. They arrive at conjectures such as *A* leads to *B* leads to *C*. *A* is typically hypothetical and *B* and *C* are expected consequences. Or, *A* could be a real event. In either case, *B* and *C* are essentially predictions. Academics who operate in policy circles even make . . . wait for it . . . *forecasts.* (See the Fed's forecasts used in monetary policy deliberations, others made by the Congressional Budget Office for fiscal purposes, and many more.)

Reality hasn't been kind to economics because it refutes the conjectures theoretical models produce. It's really as simple as that. The models define what it means to be a mainstream economist. They compose the fabric out of which economists are clothed, whereas I'm suggesting you should cut your wardrobe from a sturdier cloth.

How You Can Use This Book

"But where would I wear my fancy new duds?" you ask. Or, wordplay aside, "How can I put this book to practical use?"

Well, if you spend any of your time thinking about the economy, you might read this book to make that time more productive (and for the reasons I mentioned earlier). If you sometimes discuss the economy with friends, colleagues, clients, or bosses, you might read the book to add a fresh, real-world perspective to those discussions. Even if I only convince you of a few of my arguments, you'll gain a better appreciation of the pitfalls to established ways of thinking.

But I believe there's an even bigger reason to learn my approach, and that's to help with decision making. It's as obvious now as ever before that our major decisions depend on the economy, whether they have to do with investments, business planning, career, or other life issues. How much debt to carry, how expensive a house to buy, when to buy that house, when to expand your business if you go it alone, how to advise your employer if you don't, when to retire—if the economy has a thumb, these decisions and many others lie underneath it. One poorly timed recession or crisis can crush the cleverest of plans.

And in the financial world, in particular, we have to navigate an ever changing lineup of clever-plan crushers. The modern financial landscape

combines shifting mountains of debt with complex public policy aftershocks that jumble the normal pathways from economic to investment performance. Monetary policy makers, for example, respond to economic forces by manipulating markets more directly than ever before. With such extraordinary connections between the economy and investment results, investors who ignore the economy may be setting themselves up to fail.

I don't pretend I have the power to make these risks go away, but I can suggest methods for evaluating them and reducing their potential impact. Decision makers who understand the economy's stress points fare best, and my aim is to put you firmly in that camp. Call it the camp of smart people doing sensible things. You might have become disillusioned with outside advisors and wish to be self-reliant, or you might be looking for an approach to judging that outside advice. Either way, I can help you gain a better understanding of what might happen next in the economy. On the premise that I'm offering a richer paradigm (this isn't a humble book), I'd like to change the way you think about the economic side of your world and mine.