

# *prāxis*™

BY ALBERT LU

ECONOMIC ANALYSIS FOR CIRCUMSPECT INVESTORS

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Dear Reader,

The news is in and it's not good. For years, the mainstream media outlets have stood on the sidelines, cheerleading as the government, in cooperation with big business, set the stage for the biggest economic meltdown our country has ever seen. The Fed, Wall Street stock brokers, real-estate brokers, mortgage brokers, hedge-fund managers, and government regulators are all guilty. And who, in the end, will pay the price? You, I, and millions of unsuspecting victims, unless we take action to protect what we have.

Now, the evidence is so convincing it can no longer be ignored, even by the puppets in mainstream media. In its September 11 cover story, "Nightmare Mortgages," *BusinessWeek* exposes the fraud of option ARM mortgages and the consequences of highly leveraged home purchases.<sup>1</sup> In a September 21 article, "Flare-up," *The Economist* chronicles the aftermath of two recent hedge-fund blowups: MotherRock and Amaranth Advisors.<sup>2</sup> Similar stories have run on major TV news outlets. Even politicians have begun to warn of the emerging problems, in an

<sup>1</sup> Some option ARM borrowers make minimum monthly payments that do not cover the interest on their loan (negative amortization). The shortfall in payments is added to their balance. ARM loans offer attractive introductory interest rates but eventually reset to higher rates, which may be crippling to marginal buyers. These details are not always explained clearly to the borrower.

<sup>2</sup> According to the article, Amaranth has lost \$6B out of \$9B of managed assets *since August 30*.

unscrupulous attempt to distance themselves from the catastrophe that they, in fact, created.

To ensure your financial well-being, you must understand the simple, but often misunderstood, concepts of *prices*, *money*, and *wealth* — the focus of this month's newsletter.

*Albert Lu*

## Part I: The Lesson



### The *Wily* Coyote?

As a child, I spent many an afternoon, with eyes glued to the family television, watching the popular *Road Runner* cartoon series. Set in the rocky desert of the southwestern United States, this classic children's favorite featured a hungry coyote (Wile E. Coyote) and his nemesis, the elusive roadrunner.<sup>3</sup> The coyote is an assiduous and creative creature, yet in the end is always foiled in his attempts to capture and devour our feathered friend.

<sup>3</sup> Roadrunner (*Geococcyx californianus*), best known now for promoting the *Time Warner* high-speed internet product.

An amateur physicist, Wile E. constantly experiments with innovations in roadrunner capturing technology, most of which he acquires from the fictitious *Acme Corporation*. In spite of his elaborate schematic drawings and unlimited arsenal of rockets, explosives, and you name it, his attempts always backfire, often with painful and humiliating consequences.

I recall one episode in which Wile E. attempts to lure the unsuspecting roadrunner onto a narrow canyon ledge, with the intent of severing the ledge from the cliff using an explosive blast. The plot is executed precisely as planned except for one critical oversight — the coyote has positioned himself on the wrong side of the ledge. When the blast detonates, it is Wile E. who falls precipitously to the canyon floor.

Unfortunately, Wile E. is not as cunning as his name implies. Immediately following the blast, he observes the roadrunner shoot upward toward the sky in bold defiance of physics. Other objects also appear to race toward the sky: the canyon wall, the cacti, even the clouds. Eventually he discovers that *everything* is flying upward. By the time our coyote realizes that *he* is in fact free-falling, it is too late. All he can do is wait for the inevitable end — a small cloud of dust on the canyon floor. Poof.

In recent years, when I review the daily market news, I am often reminded of the adventures of poor, old Wile E. Coyote. Reports of surging stock prices are followed soon after by special reports on sky-rocketing residential real estate values. International currency markets spike upward also, as do the prices of gold, silver, and oil. Before long the *dollar prices* of virtually everything seem to be rising with increasing velocity.

In time, the unnerving truth shall be revealed. But will it be too late?

## Part II: Economics 101.1



### Direct Exchange (Barter)

#### Values

The entire study of economics rests on the self-evident axiom, human action: humans act purposefully to attain ends. Value scales are reflections of these desired ends, ranked according to their relative importance.

In Issue 2 of this newsletter (August 2006), I introduced the concepts of *value* and *individual value scales*. My personal value scale for beverages on July 10<sup>th</sup> was described and is repeated below.

| Rank | Beverage        |
|------|-----------------|
| 1    | a cup of coffee |
| 2    | a can of Coke   |
| 3    | a cup of tea    |
| 4    | a glass of milk |

Table 1: Beverage rankings of Albert Lu (July 10, 2006, 12:05pm)

If I am thirsty, I will act in accordance with my unique beverage value scale. This scale is not known in advance (even to me, the actor) but is, instead, revealed through my action in attaining satisfaction. For example, the relative positions of a glass of milk and a cup of coffee are fixed precisely by my willingness to relinquish the former to attain the latter.

## Exchange

While it is possible for each person to produce goods for his own consumption, it is far more efficient for him to engage in a form of exchange. Exchange allows each person to produce the goods that he can produce efficiently while trading for the goods that he desires. This exchange can be direct or indirect. Direct exchange, commonly called **barter**, is the exchange of one useful good for another, each for the purposes of direct use by the party to the exchange.<sup>4</sup> If I produce milk but desire coffee, I can attain my end by exchanging goods with someone who holds a reciprocal valuation to mine — someone who ranks milk above coffee. Through this exchange, both I and my trading partner attain higher positions on our respective value scales and hence, by definition, increase our **wealth**.

By facilitating specialization, barter is the first step in forming an advanced economy. It does, unfortunately, suffer from a key limitation — each transaction requires a coincidence of inverse-values among participants. If no producer of coffee desires milk, I will find no one with whom to barter. If my desire for coffee is sufficiently high, I may opt to stop producing milk, and instead, start producing the goods that coffee growers desire. In the extreme case, I may even resort to growing coffee myself. Nevertheless, neither is an efficient alternative for an expert dairy farmer.

Direct-exchange economies also inhibit the development of long production chains, such as the construction of a hotel, because the indivisibility and illiquidity of the final product complicate the payment of higher-order capitalists and laborers. In essence, each participant of a hotel construction owns a fraction of the final product (for instance

1/10,000 of the hotel), something that can take years to complete and can't be bartered easily.

For these reasons, an advanced, efficient economy can't rely solely on direct exchange.

## Indirect Exchange (Money)

In a system of indirect exchange, participants acquire goods not only to consume them, but also to exchange them on the market for other goods. This system is a natural evolution of the barter system and has numerous advantages.

### When Cows Go Mad

Table 2 lists partial value scales of four producers in a fictitious economy: a corn farmer, a shoemaker, a baker, and a butcher. In this unrealistic but illustrative economy, each producer produces one good and trades for other goods. The baker produces bread for his own consumption and for exchange with the farmer and shoemaker to obtain corn and shoes. It is worth noting that, in this example, each producer's own product occupies the lowest position in his value scale. This common situation is a consequence of *diminishing marginal utility*, a law of economics which states that each additional unit of a good is less valuable to the possessor than the preceding one. A baker, who can produce large quantities of bread on demand, has little use for an additional loaf. A similar argument can be made for the other three producers.

| Rank | Farmer | Shoemaker | Baker | Butcher |
|------|--------|-----------|-------|---------|
| 1    | shoes  | bread     | corn  | bread   |
| 2    | beef   | corn      | shoes | shoes   |
| 3    | bread  | beef      | beef  | corn    |
| 4    | corn   | shoes     | bread | beef    |

Table 2: Value scales of four producers in an isolated economy.

<sup>4</sup> Rothbard, Murray, *Man, Economy, and State* (Alabama: Mises Institute 2001), 160.

Inspection of Table 2 reveals a problem: While it is possible for the farmer, shoemaker, and baker to obtain the goods they desire through a barter system, the butcher is out of luck. To his chagrin, a recent mad-cow disease scare has converted half of the town's residents into vegetarians. In a direct-exchange economy, the butcher would be forced out of business.

### Money to the Rescue

The butcher's quandary is resolved naturally and efficiently through the process of indirect exchange. Once the butcher realizes that both the shoemaker and the baker desire corn, he can solve his problem by accumulating this marketable commodity (by trading with the corn farmer, who desires beef) as an intermediary store of value — a primitive form of **money** — and ultimately trading it for the goods he desires.

Any good which becomes generally accepted as a medium of exchange is money. However, not all goods are suitable candidates for this important role. In a free market, certain goods attain the status of money through a natural process of evolution. This evolution occurs one exchange at a time.

In a hegemonic economy, government officials displace the naturally evolved **commodity money** with their own **fiat money**, using the force of legal tender laws — laws that obligate market participants to accept the new money or face penalty under the law. These governments may also resort to a monopolistic control of the banking system and confiscation of the commodity money from its citizens, thereby achieving total monetary control over the economy.<sup>5</sup> These steps are taken for the ostensible purpose of stabilizing the economy,

<sup>5</sup> The Federal Reserve [monopoly] System was established in 1913. Gold was confiscated from U.S. citizens in 1934.

but in fact are pursued as a covert form of taxation.<sup>6</sup>

## Properties of Commodity Money

In theory, any commodity can perform the function of money, but few do. Free markets generally produce the most desirable goods at the lowest cost. The same is true of a free market in money. High-quality money evolves over time and has several essential properties.

### Convenience

Money must be convenient to divide, carry, and store. Goods such as rice and crude oil are widely consumed yet make poor money. Both goods are easily divisible but carry too little value to be used in large transactions. How much rice would one need to purchase a car? Furthermore, carrying or storing a flammable liquid is not only inconvenient but also hazardous.

### Durability

One important purpose of money is transporting wealth forward through time. Low time-preference individuals sometimes choose to hoard rather than invest their savings. High-quality money captures their wealth and transports it through time (without any decay of purchasing power) for future consumption. Perishable goods such as ice cream and fresh fruit have poor temporal qualities, and hence are unsuitable money commodities.

### Scarcity

The laws of supply and demand, which govern all free markets, also apply to money. If money is to retain value over time, its supply must be limited. Furthermore, its production must be relatively costly to discourage entrepreneurs from producing excess money instead of the real wealth (consumable goods) it represents. Paper, for

<sup>6</sup> Inflation is a topic of the next issue.

example, is far too abundant and economical to produce to be good commodity money.

### Acceptance

If a commodity is convenient, durable, and scarce, there is a chance that it may eventually become generally accepted as a medium of exchange — the definition of money. Acceptance is of ultimate importance since the utility of money is predicated on the holder's ability to exchange it for consumable goods. Even goods which lack the other desirable money qualities can (and do) function as money when their acceptance is widespread.

### Prices

When we speak of the **price** of a good, in most cases we are referring to its *dollar price*. This is because dollars are the generally accepted medium of exchange in our **monetary** economy. For this reason, it is natural, and usually beneficial, to reference prices in this way.

Broadly, however, the concept of price reaches beyond the narrow limit of dollar price. The price of a good is a ratio of the quantity of the good surrendered to the quantity of the good acquired in exchange. For example, a person who trades one dozen eggs for one quart of milk has paid a price of: 1 dozen/quart. The representation of the milk price in terms of eggs is arbitrary since any other good may have been chosen instead.

### Price Determination

Most people understand that, in a free market, prices are governed by the laws of supply and demand. A scarcity of milk will cause milk prices to be higher than would be otherwise. Furthermore, if the consumer demand for milk drops, prices will also drop. These are well understood ideas. However, it is commonly overlooked that every exchange involves at minimum two goods — the good(s) received and the good(s) surrendered. Hence it follows that the price of

any good is influenced by the supply and demand forces on the good itself and also on the good(s) surrendered in exchange.

If milk prices are represented in terms of eggs, a shortage of eggs will cause milk prices to drop even if the supply and demand for milk are unchanged. Conversely, a glut of eggs in the market will result in higher milk prices. This analysis holds regardless of the price unit chosen, be it eggs, cows, horses, chickens, or dollars.

## Part III: The Praxis



### The Stock Market

Most investors hold publicly traded corporate stocks as part of their investment portfolio. Under the right conditions, a portfolio rich in corporate stock can return excellent profits.

#### Recent History

The general performance of the stock market is measured and reported using a variety of market indicators. The *Dow Jones Industrial Average*, the *NASDAQ Composite Index*, and the *Standard & Poor's 500 Composite Index* are three frequently quoted indicators of the U.S. market. Each indicator reflects the aggregate performance of a unique grouping of corporations. It is worth noting that the Dow Jones is an **average** whereas the NASDAQ Composite and S&P 500 are **indices**.

The performance of the S&P 500 since 1968 is graphed in Figure 1.

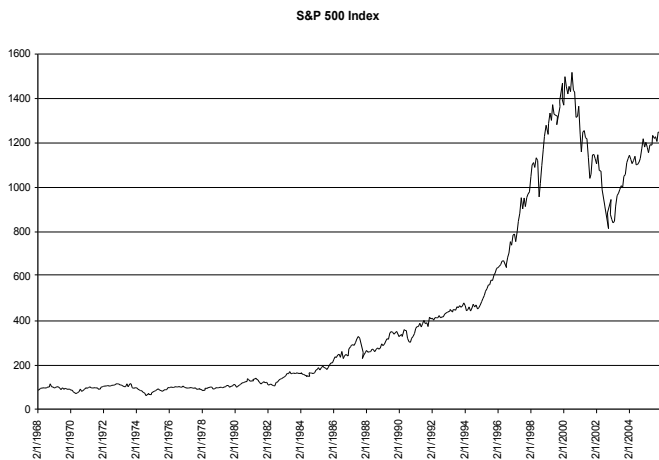


Figure 1: S&P 500 Composite Index

The graph indicates that the S&P 500 index began the year 1968 at roughly 89 and finished the year 2005 near 1280, an average annual increase of roughly 7%.

### The S&P 500 Revisited

As I discussed earlier, prices need not be considered solely in dollar terms. If the S&P 500 performance is recalculated using the Swiss franc or gold as a basis, the resulting graph is strikingly different. Figure 2 shows the additional two graphs alongside the original graph of Figure 1.

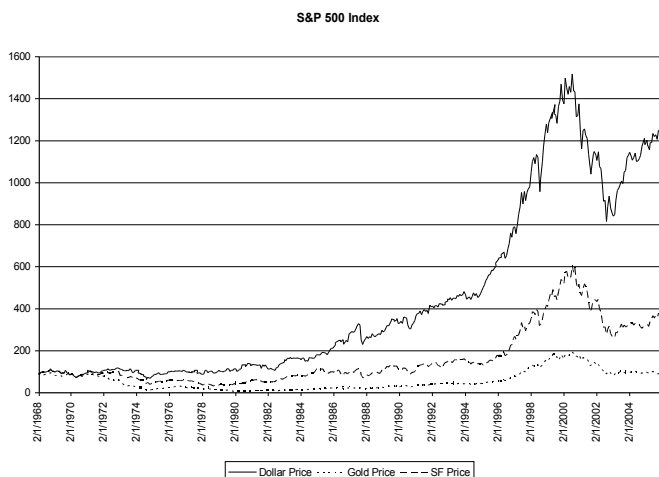


Figure 2: S&P 500 referenced to the Swiss franc and gold.

Indeed, the story is notably different for the other two cases. The Swiss franc adjusted index only reaches 377 (3.8% annually) while the gold adjusted index finishes at 81 (-0.25% annually), both dramatically lower than the original dollar-based index performance.

The circumspect investor must ask which of these provides the best representation of true purchasing power.

## U.S. Real Estate

For the past decade, residential real estate has been the darling of the investment community. Home prices ratchet up each year as more hopeful investors pour in to the bubbly market.

### Housing Performance

Like the stock market, the aggregate value of the U.S. Housing market is tracked and reported using indices. The Housing Price Index (HPI) is a broad index of housing values in various markets calculated by the Office of Federal Housing Enterprise Oversight.<sup>7</sup>

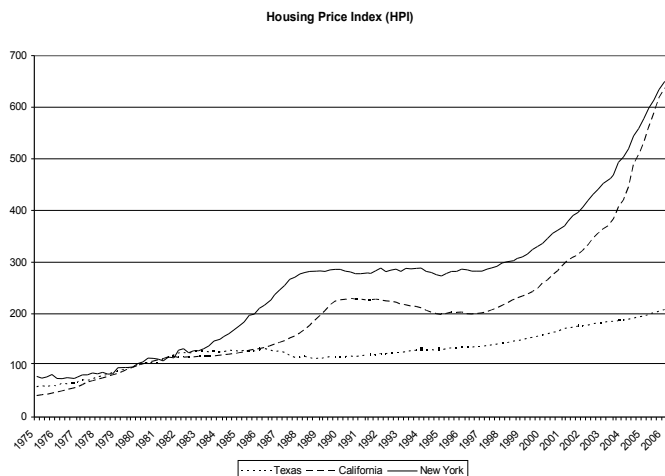


Figure 3: HPI Indices for California, New York, and Texas.

The graph in Figure 3 shows that the HPI for New York has increased from 78 in 1975 to 654 in

<sup>7</sup> <http://www.ofheo.gov>.

2006, an annual increase of approximately 7%. California also experienced strong performance, growing from 41 to 643 (9.2% per annum) over the same period. In Texas, the HPI appreciated from 58 to 211 (4.2% per annum).

Annual housing price growth in the 4% area is generally considered "normal" by real-estate experts (although they never explain why this is so). The higher growth rates on the coasts are supposedly due to the desirability of the locations.

### An Alternative Look

What happens to the HPI numbers if they are referenced not to dollars but instead to gold?

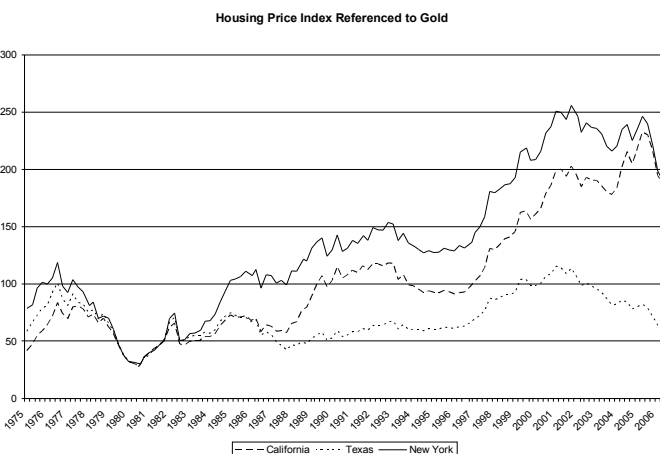


Figure 4: HPI of Figure 3 referenced to gold.

Once again, the difference is salient. The New York and California growth rates are cut to 2.9% and 5% per annum respectively. In Texas, the growth over this period was near zero (0.16%). Furthermore, all three charts appear to be trending downward in recent months.

### Real Wealth

People with fat bank accounts and expensive homes are considered wealthy by conventional wisdom. But real wealth is more than just large sums of money and sky-high housing appraisals.

Each person has many wants. Real wealth lies in the ability to satisfy these wants or ends. Paper money can't be eaten, nor can it be driven to work or worn as clothing. These ends can only be satisfied by trading money for the appropriate means: food, a car, or clothing. People without the means to satisfy their desired ends are not wealthy, regardless of how much money they may have.

### The Poor Millionaire

Imagine how your life might change if the dollar prices of life's staples rose drastically. Could you afford a new car if it cost \$150,000? Even if you had one, how far could you travel with gasoline at \$15 per gallon? How many European vacations could you afford if transatlantic airfare cost \$5,000 and hotels a minimum of \$500 per night?

At these prices, even today's millionaires would be hard pressed to afford life's basic necessities, let alone its luxuries.

### Circumspect Investors Ask "Why?"

The behavior of the market raises a number of questions. These questions are rarely contemplated by the mainstream media and even when they are, are almost never answered convincingly.

Why do the dollar prices of virtually everything rise continuously year after year?

Why is a 4% annual real-estate price appreciation considered "normal"?

Why can the government increase spending year after year without increasing taxes (and at times cutting them) or borrowing money *at an equivalent rate*?

Why, after all this time, are some investors still clinging to gold?

The answer, as you may have guessed, is inflation. But what is inflation? The answer may surprise you. ■

# Glossary

**average:** the arithmetic mean. The *Dow Jones Industrial Average* is a price-weighted average of 30 actively traded blue-chip stocks (nationally known with quality reputations).<sup>8</sup>

**barter:** the exchange of one useful good for another, each for the purposes of direct use by the party to the exchange.<sup>9</sup>

**commodity money:** money that is also a commercial commodity.

**fiat money:** intrinsically worthless money, established by fiat.

**index (pl. indices):** an average expressed in terms of an earlier established base market value.<sup>10</sup> The *NASDAQ Composite* and the *Standard & Poor's 500 Composite* are market-value weighted indices. A *NASDAQ Composite Index* value of 100 corresponds to the market value of the index shares on February 5, 1971, the date the index was introduced. The base market value of the *S&P 500 Composite Index* is set by the average aggregate market value of the component companies during the base period 1941–1943.

**monetary:** of or relating to money.<sup>11</sup>

**money:** a generally accepted medium of exchange.

**price:** a ratio of the quantity of a good surrendered to the quantity of a good acquired in exchange.

**wealth:** possessing the means to achieve one's desired ends.<sup>12</sup>

<sup>8</sup> The average is adjusted using a divisor which accounts for the payment of dividends, stock splits, cash payments, and other events. The result is quoted in points rather than dollars.

<sup>9</sup> Rothbard, Murray, *Man, Economy, and State*, 160.

<sup>10</sup> Downes, John and Jordon Elliot Goodman, *Finance & Investment Handbook*, Fifth Ed. (New York: Barron's, 1998).

<sup>11</sup> American Heritage Dictionary of the English Language, Fourth Edition, 2000.

<sup>12</sup> I find it interesting that this fundamental term is not defined in my 1396-page investment handbook.

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