Governments always modify behavior. That is the name of the game. It must always get people to do things they would not otherwise do or it would have no reason to exist.

The feds want (or appear to want) you to do things, both good and bad. They want you to separate your trash, to get your vaccinations, to obey traffic signs, to sign up for the military, to pay taxes, to fill in census forms, to buy a house. Every law and every regulation modifies behavior. Instead of buying a Canadian 2x4, you buy one from Georgia, because the feds have made imported wood more expensive. You buy a house rather than renting one because the feds made interest payments deductible. You drive at 60, not at 65, because you can’t afford to get any more speeding tickets.

Of course, some behavior modification seems clearly beneficial. The feds punish people for murdering one another, for example. They don’t like it when a sicko puts razor blades in Halloween apples (though we suspect it never happened). They especially get out of sorts when another government muscles in on their territory. Government is essentially a protection racket. You pay first for protection from your own government... and second for protection from other governments (aka "national defense").

Protection rackets work best when the victims believe the government operates fairly and efficiently, and for their own benefit. Then, with little resistance, the cost of providing the service goes down while the profit margin (to be distributed among the feds and their cronies) goes up.

As Dan shows in this month’s letter, the feds modify our financial behavior... and our brains. And now, most investors believe things that aren’t true – that prices don’t matter, that debt doesn’t matter, and that a company can be a great success without earning any profits.

For the last 30 years – ever since Alan Greenspan began to protect investors from losses after the crash of ’87 – every downturn has been a buying opportunity. Each time the market tried to correct – 1987, 2001, 2007 – the feds came in with cash and credit to drive prices up again. A whole generation of investors has known nothing else. Its thoughts and its behavior have been modified, intentionally, by the government. Day after day, it does what it has been trained to do: buy.

The immediate focus of the Fed’s rescue effort was to lower interest rates. Pushing rates down would pay obvious dividends, or so the authorities believed. People wouldn’t bother to save. Instead, they would spend. In a consumer economy, more spending should mean more sales, more profits, more jobs, and more glory for the financial geniuses who made it happen.

But lower interest rates would diddle both ends of the supply chain... from production to consumption. At a 5,000 year low, businesses and investors could hardly resist borrowing either. Then, they would venture further out on the “risk curve,” giving their money to more dodgy projects – either in debt or equity – in search of a higher return.

The stock market should go up (as indeed, it did). This should make rich people feel even richer, encouraging them to take more cruises and invest more money.

And if stocks didn’t go up on their own, management could use record-low borrowing rates to do a little engineering. They could buy their own shares, thereby demonstrating the value that the market had failed to discover.

The possibilities were almost endless. The feds created a world without financial gravity. There was nothing to keep investors’ feet on the ground.

In the past, interest rates were tethered to the real world of time and resources. Capital wasn’t free. Interest payments
had to be made. Projects needed to make enough to pay for the resources that went into them... including the interest on borrowed capital. That was what kept investors from flying out into space.

But push the rates down low enough – even below zero – and you are suddenly lost in space, forced to wander the cold galaxy in search of any real yield at all.

Now you could reach for the stars. Of course, you might also break your neck. But the feds didn’t worry about that. Instead, they claimed to have stretched out a net – a put option under the entire capital structure – to make sure that no one gets hurt.

And for more than 30 years, no one has; every dip has been a buying opportunity. And now, circa 2017, investors are practically a new species – sired by the progenitors of the spendthrift race, Greenspan and Bernanke... schooled by the Sage of the Plains to remain fully invested all the time... and grown fat and sassy on a diet of fake money.

For years now, we've been exploring how the fake-money system works. For our purpose here, a little fake money may actually do some good (or maybe not). A lot of it, on the other hand, always does harm. And between good and harm can be a long slide of declining marginal utility... where debt grows and growth falls.

What’s more, a fake-money system is dishonest. It transfers wealth from people who earn it to the sectors favored by easy credit and the Deep State. That is, it moves money from gritty heartland producers to lawyers, politicians, lobbyists, administrators (health and education), insurance companies, tech entrepreneurs, military suppliers, financial engineers, and Deep State cronies on the coasts.

As time goes by and the harm becomes more apparent, so does the dishonesty. Then, people start to drag their feet and duck their heads.

Ordinary working stiffs know they are being cheated. But they don't know how. Or by whom. They turn to Donald Trump hoping for change. But the Trump brand neither recognizes the real problem nor has any intention of solving it. Nor can Congress respond effectively; its members, too, need funding from the fake-money system and its biggest beneficiaries. The voters are stuck. The system can’t be reformed.

Meanwhile, consumers can take on little more debt. Businesses’ debt, too, must be reaching towards its peak. And government can only go further into debt by “monetizing” its deficits... that is, by getting the central bank to print up extra currency to cover its expenses.

As Dan warns, this will blow up, big time. Then, investors will get a terrible shock. Gravity will reassert itself. Lenders will want a real return on their money. Credit will be hard to get. Stocks will crash. High-yield bonds (which they bought at yields barely above U.S. Treasuries) will sink. The fake money will lose value amid bubbles and depression. Volatility will be come back with a flourish.

From then on, behavior modification by the feds will become harder and more expensive. People – sensing both dishonesty and the incompetence – will resist. The elites will have to work harder (at greater expense) to keep them in line. Once desperate to get into the high-yield investments, they will become desperate to get out. Instead of believing they should stay fully invested all the time, they will never want to look at another stock or bond as long as they live. And rather than lend the government money at a net rate below zero, they won’t want to lend at all.

This is behavior modification too, of course, but not what the feds were aiming for.


Regards,

Bill Bonner
Chairman, Bonner & Partners
The Bill Bonner Letter

This month’s Bill Bonner Letter considers the possibility that we’ve been doing it all wrong.

We’ve been taking the long view and charting the course of U.S. imperial decline. The $20 trillion debt, the annual deficits, the once-in-a-generation, algorithm-driven sell-off that could crash the stock market, the looming pension, and entitlement boondoggles that will expose the bankruptcy of the Fed; all of these are unavoidable and dire.

But people are strange and irrational. They’re also prone to mental habits which produce poor investment decisions. I’ll show you the top five mental mistakes you could be making right now. Those come courtesy of the latest rage in economics: behavioral finance. Richard Thaler from the University of Chicago has just won the equivalent of a Nobel Prize for his work in this field (because economics is not a “hard” science – or arguably even a science at all – the Nobel Committee doesn’t give an award for it).

It’s a timely subject. But it’s also worth knowing more about because it’s one of the only explanations left for why investors keep buying stocks at these prices. It’s also a discipline worth understanding for another reason. Thaler and fellow academic Cass Sunstein have argued that policymakers (the Swamp creatures in Washington) should use the science behind behavioral economics to “nudge” people into making more rational decisions.

Thaler, for example, was an early advocate of India’s demonetization of cash (the elimination of all 500- and 1000-rupee banknotes). It was the correct policy “nudge” to force people away from the irrational desire to hoard cash. The core of the argument is that some people (the elites) know what’s better for you than you do. They should use that knowledge to gently steer (coerce) you into better, more rational decision-making. Nuts!

A Bull Market for Quacks

I’ll come back to Thaler and the dark side of behavioral economics. I’m also going to take another view of volatility. “Selling volatility”—which is another way of saying stocks will never go down again—is a crowded trade now. If you’re looking for a signal that the market could drop quickly, you’ll want to read what I have to say. If you’re a speculator, there’s even a trade on offer.

Yet maybe all this hand-wringing and gnashing of teeth is for naught. Maybe the Dow will never go down again anyway! 2017 will go down as “The Year That Volatility Died,” according to Charlie Bilello, head of research at $200 million investment advisor Pension Partners. I believe he had his tongue firmly in his cheek when he tweeted the following:

Dow closes at an all-time high for the 50th time this year. It may never go down again. $DJIA

Unless the Fed decides to buy stocks directly to prevent the next crash (something entirely possible – Japan has been doing it since 2010) you can be sure the Dow will go down again, someday. Someday this bull market’s gonna end!

The Permanent Bullish Bias of Wall Street

And how to insure your brain (and your portfolio) against its damaging effects

By Dan Denning, Coauthor, The Bill Bonner Letter
But it’s been almost a year since Donald Trump shocked the Swamp with his election. Trump’s done magnificent work since then. The S&P 500 is up over 400 points and nearly 20%. And the Dow?

The blue-chip benchmark—a celebration of the stocks with the largest share prices getting even more expensive—is up nearly 5,000 points in the last 12 months. It’s a 26% gain for investors who bought on November 9, 2016. But even if you were late to the party, the index has made 51 new all-time highs in 2017. The move over 23,000 in late October takes it into record territory in its 121st year of existence.

Look at what’s happened to all U.S. stocks since 2009. Big, small, cheap, expensive, techs, financials, industrials, and even materials—the tide has lifted all boats. The broadest measure of U.S. stocks is the Wilshire 5000 Total Market Index. It’s up over 200% from the low in March of 2009.

The bull market since then – eight years old and going strong – is now the second-longest (second only to the tech boom bull) and the second-largest (in terms of percentage gains... the bull between October 1990 and March 2000 was up 417%) on record. Given those numbers, you might argue this market can go even higher. If it’s going to be the biggest, strongest, and longest bull in history, it has to go higher.

More to the point, what’s going to stop it? Higher interest rates? A recession? An external shock like a North Korean electromagnetic pulse detonated high above middle America?

In the past few months, we’ve looked at valuations (mean reversion) and liquidity (higher interest rates) as two potential bull market killers. Yet valuations keep on stretching. Robert Shiller’s Cyclically Adjusted Price/Earnings (CAPE) ratio is above 31, higher than the level before the Black Tuesday crash of 1929. Shiller’s ratio is an inflation-adjusted average of earnings over the last 10 years, and is supposed to give you a longer-term view of whether the market is cheap or expensive.

It’s still below the all-time peak of 44.18 from the tech boom. It’s not cheap. But it’s not the most expensive ever. That’s ammunition for the bulls who believe there’s more blue sky ahead.

If you’re not a fan of Shiller’s ratio, the trailing 12-month P/E on the S&P 500 is 25.51. Its average is around 15.6. By the way, this more conventional P/E ratio peaked out at 123 in May 2009, well after the crash was underway. That might seem strange that stocks got more expensive, on an earnings basis, after the crash. The reason?

Earnings fell much faster than prices in 2008 and 2009, at least for S&P 500 companies. It was an earnings Armageddon. We found out then what we’ll find out next time – that many major corporations had earnings that disappeared when leverage collapsed. Earnings suffered anyway with the shock to the economy that the market collapse generated. They took a further blow for companies that added to earnings by speculating on high stock prices (or their own stock).

This gets to the heart of the subject I raised last month: in which sectors or industries will we see the kind of earnings growth that justifies today’s high multiples? I have no obvious answer. Energy, biotechnology, and healthcare are certainly candidates. But it’s a subject I’m sure we’ll return to in 2018. In the meantime...
Don’t Forget the Fed

The Federal Reserve Open Market Committee (FOMC) meets next on December 12 and 13. The Fed should raise rates then, and as many as three times next year, according to Boston Fed President Eric Rosen- gren. He’s a non-voting member of the FOMC. But he’s in the hawkish camp that says with the official unemployment rate at 4.3%, the Fed should get ahead of the inflation curve and raise rates now.

The minutes from the September FOMC meeting showed a split between the hawks and the doves. Current Fed Chair Janet Yellen is “perplexed” by the lack of inflation in the Fed’s data. The Personal Consumption Expenditure (PCE) metric is, as you can see at right, tracking below Consumer Price Inflation (CPI). Both are below the Fed’s target of 2%.

Will The Fed Tighten With PCE And CPI Below 2%?

You may hate reading about the Fed as much as I hate writing about it. And there are full-time Fed watchers who pay a lot more attention to it than I do. But we do have to pay attention to it, especially since Donald Trump is likely to announce his nominee for new Fed chair in the next few weeks. That will tell you whether you can expect liquidity to remain free and easy.

The Fed may well decide not to hike rates while the economic picture is confusing. If that’s the case, then the stock market can put aside the “rising rates” worry for a while. Tax cuts, and whether they will happen this year or next year (or at all), will be the main driver of the narrative for the rest of the year. And you might even see the Santa Claus rally come early!

I’m being a little light-hearted about how much higher the rally can go. But my serious point to you is that whatever the Fed says or does now, it can always reverse itself. Now that the market is addicted to low rates and bond-buying by central banks, I find it hard to believe that rising rates and the shrinking of central bank balance sheets won’t lead to less liquidity in the market and thus, falling stock prices.

That said, it hasn’t happened yet. The Fed has gradually reduced its bond buying without tanking the market. So far, so good. But liquidity always looks plentiful until it drains away. And then you have a whole different set of problems.

A Machine-Driven Meltdown

Let me remind you that no one knows how algorithmic-driven index funds will behave in the next sell-off. (We detailed the worst case scenario of a so-called “sell cascade” in our September 2017 letter.)

Let me also remind you that the last time Wall Street was convinced it had a perfect way to hedge risk—with portfolio insurance in the late 1980s—the Dow fell by 22.6% (508 points) in one day. October 19 marked the 30th anniversary of the 1987 crash.

Thirty years is apparently long enough to forget everything worth remembering. I fear the growth of passive investing and index tracking exchanged traded funds (ETFs) is setting up the market for another self-reinforcing crash. Index tracking ETFs have over $3 trillion in assets under management. Add another $933 billion in quantitative hedge funds with largely the same index tracking methodology.

The trouble with algorithms is that they’re not contrari- ans. They’ll do what they’re programmed to do and the sell order will be executed more quickly than any pot-bellied
trader from Queens could ever do. Columnist Ben Levisohn wrote about what he called “Black Monday 2.0” in a recent Barron’s article. Ten years after the last crisis, the financial system is still more fragile than most investors know because:

Market participants have come to rely increasingly on computers to run quantitative, rules-based systems known as algorithms to pick stocks, mitigate risk, place trades, bet on volatility, and much more—and they bear a resemblance to those blamed for Black Monday.

The proliferation of computer-driven investing has created an illusion that risk can be measured and managed. But several anomalous episodes in recent years involving sudden, severe, and seemingly inexplicable price swings suggest that the next market selloff could be exacerbated by the fact that machines are at the controls. […]

The rise of computer-driven, rules-based trading mirrors what has happened across nearly every facet of society. As computers have grown more powerful, they have been able to do what humans were already doing, only better and faster. That’s why Google has replaced encyclopedias in the search for information, why mobile banking is slowly replacing bank branches, and why—someday—our cars will be able to drive us to work. And it is also why Wall Street has embraced computers to help with everything from structuring portfolios and trading securities to making long-term investment decisions.

How much progress have we really made? Not much. I was recently at dinner with some long-time colleagues at an Afghan restaurant in Baltimore (owned, incidentally, by former Afghan president Hamid Kharzai’s brother). These are people who have in and around the financial publishing industry for two decades. They were also baby boomers, whereas I am technically a Gen X-er.

The discussion was over what percentage of your portfolio you should allocate to bonds. As I showed you here last month, the conventional wisdom is that your allocation to fixed income (usually government bonds) should match your age. As you get older, you sell riskier stocks, giving up the equity risk premium in exchange for reliable income. That’s the conventional thinking.

But one of my colleagues asked a great question: “Who is going to buy all these stocks we have to sell?”

She’d accepted—incorrectly in my view, the wisdom of allocating more of her money to government bonds—but was correctly worried about whether she’d be able to sell her stocks at high prices. The millennials—flush with student debt and more interested in spending money on experiences rather than possessions—are in no position to buy stocks at these prices.

“You’ll have plenty of buyers,” I said, “but not at these prices. It’s going to take a good old-fashioned crash to bring in a new generation of equity buyers. These things go in cycles. I’d sell while you can. And I’d start reading The Bill Bonner Letter if I were you. You’ll own way too many government bonds if you take the conventional view of asset allocation. And you’ll blow up when the Fed defaults on government bonds.”

The rest of the conversation was tense. The dessert was excellent, though. And I think the point struck home.

The time for you to start thinking about these big sea-changes in the stock market is now, before the tide goes out. If you haven’t done that yet, I recommend you go back and read our July 2017 letter – What to Do When Doom Awaits – where I laid out an alternative asset allocation strategy based on our view that markets always mean revert. It’s just a matter of timing.

The Volatility Signal

Speaking of timing, let’s talk volatility. The Volatility Index (VIX)—otherwise known as Wall Street’s “fear index”—made a new all-time low in October at 9.19. It’s down 90% from the 2008 crisis closing high of 79. October, which has seen some of Wall Street’s worst crashes, was the least volatile month in VIX history.

Incidentally, margin debt – a popular greed indicator – on the New York Stock Exchange (not including “shadow margin,” which I showed you about two months ago) hit a record in July at $549 billion. Then it hit another record in August at $550 billion. The September figures aren’t out yet. But do you find it disturbing that margin debt has reached record highs precisely when we’re on pace to record the lowest ever annual volatility on the VIX?

Let me translate the risk in laymen’s terms for you. The VIX tracks buying and selling activity on S&P index options. When investors are nervous about the future, they hedge their risk by buying options, which are (in addition to being speculative securities) an instrument for insuring yourself against big market swings. When the VIX is low, it tells you investors don’t think there’s anything to worry about.
They’re not buying insurance.

And maybe they’re right. Official inflation figures are low. Central banks have been quick to respond to any financial or liquidity crisis with easy money and more liquidity. And if you believe it, there’s a theory going around that there’s a synchronized global recovery taking place. Why worry? Have a look at that chart!

**Selling Volatility Has Been The Best Trade of 2017**

The opposite of fear is greed. The chart nearby chart shows you how reckless the greedy can get. Instead of buying insurance against a future crash—not a bad idea when valuations are historically high, margin debt has hit a new record, and volatility is at an all-time low—speculators have done the opposite. They’ve been “selling” volatility.

Think about it as a bet, and it’s not as complicated as it sounds. When you “sell volatility,” you’re betting that volatility won’t rise again any time soon. You’re betting it will stay the same or even fall. It’s the kind of bet you make when your brain’s been marinated for eight years in easy money. You form the kind of cognitive habits (or biases) that I’ll tell you about later.

What you see above is just one example. It’s a performance chart for the Credit Suisse VelocityShares Daily VIX Short-Term Exchange Traded Note (XIV). It’s a security that’s designed to make money when the volatility of the S&P 500 goes down (for this particular security, the desired move has to happen over a one- to two-month time frame).

How does the security manage to give you a 5x inverse return on the VIX? Even if I could easily tell you, you wouldn’t want to know. Its performance is supposed to be inversely related to the S&P VIX short-term futures index. Then, abracadabra, using VIX futures, you get a theoretical leveraged return. You make money when volatility goes down.

Since the security first debuted in 2010, it’s been a pretty good trade. The exchange traded note in question is up 118% year-to-date a, up 164% in the last 12 months, and up 800% since 2011. The lower volatility goes, the better the trade looks. But that’s exactly what has me worried now.

**VIX Short-Covering Catastrophe**

What will happen when everyone who’s “sold volatility” short tries to cover their bet at the same time? You’d normally get what traders call a “short squeeze.” They race to buy back what they’ve sold short, driving the price of the shorted security up higher, squeezing out more shorts. You get a massive volume spike.

In this case, VIX sellers in the futures market would become VIX buyers. Volatility would spike. And as with other short-covering spikes, traders might be forced to sell other assets to buy back their shorts. The fact that all this is happening in the futures market, with considerable leverage, makes the scenario that much more frightening.

But does it sound a bit opaque to you? Could a wider fall in stocks be triggered by an isolated event in the VIX futures market? It sounds like a remote possibility. But so did the idea that residential mortgage-backed securities could threaten the stability of the entire global financial system.

In principle, the two phenomena seem related: investors...
speculating, with leverage, and confident in the belief that a highly improbable event (a crash in U.S. house prices/a spike in the VIX) would never happen, or at least not happen so quickly that they couldn’t unwind their trade or leave someone else holding the bag.

If anything, the VIX trade seems almost deliberately reckless. Who would really be willing to bet that volatility will not rise again? The only kind of idiot who makes that trade is someone who’s never seen a bear market or believes the Fed will never allow one. You want to make sure that idiot isn’t you, or isn’t managing your money.

If you think I’m exaggerating the risk, then please take the word of Edward Chancellor. Chancellor wrote Devil Take the Hindmost: A History of Financial Speculation. I met him earlier this year at a seminar organized by Russell Napier on the history of financial markets. Chancellor wrote the following in late October, pointing out that 1929 may be a better comparison for today’s market than 1987 (emphasis added is mine):

Speaking at the Grant’s Conference in New York earlier this month, Frank Brosens, a former Goldman Sachs partner and founder of investment firm Taconic Capital, pointed to a number of current investment strategies which, like portfolio insurance, have the potential to unsettle the market by unleashing large-scale automated trades into a downturn.

For a start, insurers have been selling principal-protected variable annuity products, which are forced to reduce market exposure when volatility rises. Commodity-trading advisers pursue momentum strategies which require selling stock futures when the market declines. Another hedge-fund strategy, popularized by Ray Dalio of Bridgewater Associates, is known as risk parity. This involves leveraging a portfolio of government bonds, equities, and other assets based on their historic volatilities and correlations. If volatilities or correlations move abruptly, risk-parity managers might have to decrease leverage and, possibly, also reduce their equity positions.

In addition, says Brosens, exchange-traded funds which hold stocks on leverage must cut their exposure when the stock market declines. Most worrying of all are the ETFs which sell volatility futures: implicitly leveraged and roughly five times more volatile than the stock market. In the event of a large enough volatility spike such strategies will blow up. Brosens estimates these programme-trading strategies have in aggregate a total stock-market exposure north of $1 trillion dollars - a somewhat larger share than portfolio insurance back in 1987.

Still the lesson that most have taken away from what happened three decades ago is that stock-market crashes, however severe, aren’t a concern for long-term investors - especially when the Fed has their back. Yet it’s easy to overlook the fact that financial-market conditions in October 1987 were more favourable than they are today.

If you’re still with me, you’ll know I’m not publishing this analysis for your entertainment. This is a warning. Just like it was a warning the month before. And the month before that.

I would much rather miss out on another 20% rise in stocks from here than own them during the “large-scale automated” selling of a downturn. We’re not talking about a crash like 1987, 2001, or 2007, where it took just a few years to recover. We’re looking at a once-in-a-generation collapse.

Consider this: the Dow didn’t retrace its pre-1929 levels until 1955... Japan’s Nikkei is still down 45% from its 1989 high. Who can afford to wait 30 years... or more? Can you?

And keep in mind, all this assumes the downturn will be the result of the usual suspects: too much debt, too much leverage, too much greed.

I haven’t even considered the possibility that a malignant actor (financial terrorist) could precipitate the feedback loop I’ve described on purpose! If you wanted to do a lot of damage to a fragile financial system, you wouldn’t have to blow up a building. You’d just have to impersonate a trader and press a few buttons.

The Pentagon already knows about this risk. The Defense Advanced Research Projects Agency (DARPA) recently convened a meeting of hackers to help it understand how cyber terrorists might try and wreak havoc on financial markets. They are well aware that highly complex systems tend to be highly fragile.

But even if it isn’t a rogue hacker (or the Chinese, or the North Koreans, or the Russians, or even a financial “false flag” from within America’s intelligence community), the market is vulnerable enough. The conditions are ripe. The danger is high. Why do so few people see it? Do you see it?
A Nudge in The Wrong Direction

Richard Thaler can probably tell us why so many people fail to see what we see. It’s not that we’re perceiving different objective realities. It’s that our brains are making different sense of them. Below, I’m going to introduce you to five of the most common cognitive biases in investing. As always, I’m a big believer that self-knowledge—even knowing what your bad habits are—is better than ignorance.

And by the way, congratulations to Thaler. Even though he did not technically win a Nobel Prize, he’s at least been acknowledged for putting some thought into how we think. The announcement was made in Stockholm in early October.

As a point of order, there ISN’T a Nobel Prize for economics because economics is not a science. With economics, instead of a theory of relativity or, say, germ theory, you get theories about interest rates and human behavior. How are these different?

The former kind of theories are observable (usually), testable (in the lab), and repeatable (you get the same result if you run the experiment in the same way, even when you’re in different places). These Nobel-winning theories either advance our understanding of the physical world, or they don’t. That’s why the winners in the hard sciences aren’t terribly controversial (even if it isn’t always easy to understand the accomplishment that’s being recognized).

Thaler has won for his contribution to behavioral economics. What’s behavioral economics? It’s the study of how human beings make decisions, especially with money.

That study involves a lot of psychology (also a pseudo-science with no Nobel Prize to show for itself). It involves a more detailed understanding of the different kinds of cognitive habits or biases we have. It’s really the study of how we think we know what we know, and how we make decisions based on what we think that knowledge is (consciously and unconsciously).

If you’re interested in this subject, I’ve included an image from Wikimedia showing the multitude of cognitive biases that academics think we have. Given the sheer number of them, it’s amazing we know anything at all! And maybe we don’t! Maybe we’ve just convinced ourselves we do because it’s useful to believe some things as if they were true.

But in the interests of practical knowledge, I’ve highlighted five cognitive biases that I think affect most investors.

If you can identify and understand them, then you can make sure you don’t fall prey to them. Here they are.

1. **Anchoring.** Anchoring occurs when your expectations about the future rely too much on the first piece of information you have about a situation. I can give you a non-investment example. I was recently involved in the sale of a business in which a former shareholder was told by a third-party he could expect the business to be sold for between $10 and $15 million. Even though that number had nothing to do with the enterprise value of the business—much less what someone would actually pay for it—the figure was anchored in his mind. His emotional attachment to the initial expectation made the whole negotiating process much more arduous. An investment example is “Siegel’s Constant.” That’s the expectation that your after-inflation return from stocks will be 6.5% to 7% per year, based on the work of Jeremy Siegel in his book *Stocks for the Long Run*. Siegel defines the long run” as a 20- to 30-year period—long enough to survive the periodic cyclical drawdowns in your portfolio caused by recessions, the business cycle, and wars. The trouble is, a lot can happen a 30-year period. If you experience said drawdown near the time you expect to retire, your portfolio won’t have enough time to recover—even assuming stocks will generate a 7% return every year, after inflation.

2. **Availability heuristic.** This happens when you overestimate the importance of something simply because it’s the most immediately available explanation. Mainstream financial headlines are rife with this cognitive bias. “Stocks rise on Yellen Speech!” “Stocks fall on Trump speech!” “Dow closes lower on poor employment report.” I’ve made these examples up. But you see what I mean. If you make no effort to understand things at a more fundamental level, you’re likely to fall for these easy explanations. They’re not explanations at all. And they convey no knowledge or understanding about what’s going on in the market.

3. **Recency bias.** If you’ve ever heard Bill’s bell curve speech, you’ll recognize this one. It’s the tendency to over-weigh recent events when you’re planning for the future, simply because they’re the most recent in your memory. Why will stocks go up this year? Because they went up last year? Why will Facebook be the best tech stock next year? Because it was the best tech stock last year? This bias can be difficult to manage because there’s a whole school of investment thought based
on momentum as the most important factor in your long-term returns. Momentum is when last year’s winners win again and last year’s losers lose again. Momentum can and does work as a short-term strategy. But by definition, momentum is something that changes (stocks go from cheap to dear and back again).

4. **The Endowment Effect.**
This is when you place more value on something because you own it. Because it’s yours, and you bought it for a reason, and you are sitting on a gain (or a loss), you are more likely to over-value it. This can prevent you from selling a profitable stock, where everything you expected to happen actually happened. Or it can lock you into a losing position, where you believe your original reasoning was correct and the market is wrong. While it’s good to have the courage of your convictions, how strongly you feel about a stock has nothing to do with whether it’s a good investment or not. You’re likely to feel strongly about it if you own it. You can combat the endowment effect with trailing stops and stop losses.

5. **Confirmation bias.** You are likely to be guilty of this bad habit if you surround yourself with people who agree with you. You see a lot of that in the world today, especially on social media. It’s lethal in the investment world. If you only listen to people who already agree with you, you’ll never learn anything. Worse, you’ll likely get blindsided by some event or risk you had no idea was out there because no one in your circle of sources knew about it. We all like to hear other people tell us how smart we are. Practice telling yourself how dumb you are. And if that doesn’t work, practice telling other people how dumb they are. Remind yourself that you know less than you think and nothing is very certain (like volatility staying low forever).

You can tell I like the subject of behavioral economics. Like Austrian economics, it’s most concerned about human action, whether it’s rationally motivated or bat-shit crazy.

For both, the study of economics is about the quality of our knowledge.

But Thaler’s win, and the win for behavioral economics is also timely, given what we’re trying to do in *The Bill Bonner Letter* this year. We’ve looked at markets and tried to make sense of prices through several different prisms: valuation, liquidity, and interest rates. Now we can add human behavior to the list.

This is the part of economics that really is the most interesting. It’s the study of the cloudy human mind, the greedy black human heart, and the nervous and possessive human soul (I’m taking a rather dim view of how people tend to act). It can tell us a lot, or at least give us a lot to talk about.

What behavioral finance does not tell is what the chart above means. Is the Nasdaq headed to 7,000 this year? Will it “melt up” like the S&P? Will the “animal spirits” of investors keep bidding up values because people... just... feel good about the future? Or will good vibes give way to sober reality and mean reversion and see the market fall? What do you think?

**Which Cognitive Habit Best Explains The Run in The Nasdaq’s Performance Since 2009?**

As useful as it is, there is a dark side to Thaler’s theory. That’s the real criticism of behavioral finance. It makes it tempting for the authorities to try and manipulate your brain.
If you think you understand how and why people make decisions with money, then you might also think you can influence those decisions (for the better, of course) without people knowing you’re doing it.

You might do this in the belief that you’re exerting a positive influence.

But really, the “nudge” you give people—which is Thaler’s term for how to deploy behavioral finance as a policymaking tool—is a form of psychological manipulation. For example, Thaler was an early and vocal supporter of India’s demonetization of cash last November. In a tweet, he said, “This is a policy I have long supported. First step toward cashless and good start on reducing corruption.” That’s a hell of a nudge. From an allegedly rational perspective, the hoarding of cash or the use of it when cashless payment systems exist (and can be tracked and taxed) is both inefficient and undesirable. To nudge people out of their irrational love for dirty paper money, you ban cash.

Modify behavior through policy. Everyone’s a winner!

But the heart of the idea, from a policymaker’s perspective, is that if we understand why people do things, we can then make them do the things we want them to do. A more charitable understanding is that a little self-knowledge can prevent a lot of self-harm (in financial terms).

But do you see the insidious element of coercion involved? I do! It reminds me of the experiments conducted by the behavioral psychologist B.F. Skinner. Skinner tried to “condition” responses in his test subjects (rats and pigeons) by rewarding them or punishing them for the correct behavior. All of which is fine if we’re talking about pigeons.

But pigeons aren’t people. And not all people are rats. It’s dangerous to personal and financial liberty if policymakers believe we are all part of their big monetary experiment. And that we can be rewarded or punished for what THEY believe to be the most rational behavior for US. They are not us, and would have no idea what’s best for you, or best for me, or best for Richard Thaler.

We are, sadly, living in just such an experiment. And even though the regular price signals of the market have been distorted, there are still some signals telling you to be alert and aware of the danger in markets right now. Maybe we’ve all been conditioned to buy (fighting the Fed is painful). But don’t be a rat! Certainly not a rat on a sinking ship.

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Find Yourself a Natural Hedge

Just to be clear: I expect volatility to roar back. It’s become vogue to say that there can’t be a crash because everyone’s talking about it. Crashes never happen when everyone is worried about a crash. They only happen when no one thinks a crash is possible. Right?

Maybe in the past. But you don’t need euphoria to precede a bear market. Sometimes you just need boredom. Boredom—that stocks go up no matter what and rates stay low no matter what—has lulled investors into recklessness. It’s ennui you have to worry about, not euphoria.

For speculators, you can buy options on the ProShares Short VIX Short-Term Futures ETF (SVXY). It’s similar to the ETN I described above. But it’s “optionable.” That means you can go short the VIX sellers by buying put options on SVXY. Please keep in mind this is something I strongly suggest you NOT do. Why?

It’s pure speculation. For one, a quick scan of the contracts available shows that it’s not a terribly liquid market. That’s one strike. But it’s more than that.

You can’t really hedge against rising volatility by speculating on it. You can “buy volatility” in the futures markets or with this ETF. And if you’re right—which means you’re right before the options expire worthless—you CAN make some money. But that is playing with fire.

And I should point out there’s nothing to prevent the Fed from reversing itself, cutting rates, or expanding its balance sheet again (buying up anything in sight) to keep volatility low and stocks high. If they do that, volatility will stay in its coma. If, on the other hand, the insiders are positioned for a system crash, where they sell at the top and buy back in at fire sale prices AFTER the crash, then volatility is nearly certain to explode.

Is there another way of being “long volatility”? Put another way, is there a single investment that goes up in value when volatility rises? The answer to that is obvious: insurance becomes valuable when calamity strikes.

But instead of buying options or financial instruments, I suggest you insure your financial risk by “de-financializing.” This is easy to do mentally and harder to do physically. Mentally, it means accepting the analysis I’ve presented this month. It means not being seduced by higher highs or convinced that without euphoria, the market can’t crash.
And physically? That’s another story. I’m finishing this month’s letter from the lobby of a La Quinta Inn in Dickinson, North Dakota. I’m on a week-long road trip in the Rocky Mountain West (Nebraska, South Dakota, North Dakota, Montana, and Wyoming) to find a “bolt hole.” Specifically, I’m looking for small, but liveable American communities where you could safely make a second or third home to “get away from it all” if you had to.

I’ll tell you more about what I’m looking for in next month’s letter. And if you’re already familiar with the idea of a bolt hole, I’d be happy to hear your suggestions. Please send them to feedback@bonnerandpartners.com. Put “bolt hole” in the subject line so I know what it’s about.

Until next month!

Dan Denning
Coauthor, The Bill Bonner Letter

P.S. Dickinson is a charming, small town. Many of the buildings and streets are named after Teddy Roosevelt, for some reason. I haven’t figured out why yet. Teddy Roose-
Dan’s Notes From the Road

Editor’s Note: After living abroad for years, Dan is rediscovering his American homeland by hitting the road. Today, he shares a few stories, and pictures, from his travels through the American heartland.

There are a couple of reasons to go on a trip like this. First, when you’ve lived in the heart of London for the last two years, you crave a bit of open space. You go from being surrounded by 8 million people in the same city... to five states whose combined population is less than 8 million people. Talk about a breath of a fresh air!

We started up through eastern Colorado to get to Valentine, Nebraska. That’s where my grandmother left when she was 16 and pregnant, apparently. We couldn’t find any trace of the family in the two small cemeteries on either end of town. We did find Bigfoot, though.

And I learned that Valentine used to be divided right down the middle of mainstream into the Mountain and Central time zones. You see, America has always been divided. The city apparently sprung up due to the railroad companies building lines to move cattle and crops east. But before that, it was the water and the trees that must have attracted early ranchers and settlers. It lies on the Niobara River, I believe. You don’t see a lot of water in the plains, or shade. When you find both, it’s not a bad place to settle.

I didn’t include any pictures of the Badlands in South Dakota. There’s not a lot to see... or... there’s one thing to see... over and over again. It’s pretty in its own way. If I knew more about geology, I could tell you about the massive old inland sea in this part of the world... the fossil record from the Cretaceous period (dinosaur fossils... heaps of them) and the erosion patterns that created the Badlands. But that’s as much as I know.

Last time I went through this part of the country, a few years ago, I stopped at the Minuteman Missile National Monument (seriously) just east of the Badlands. The Great Plains were/are apparently perfect for stashing the bulk of America’s land-based nuclear arsenal. For one, the Soviets would have to lob missiles over the arctic and across all of Canada to get to places like South Dakota and Nebraska. But I suspect it was mostly because you could bury thousands of missile silos here and you wouldn’t bother anyone but the antelope. Must have been a lonely job for those Air Force guys, living in bunkers, before the internet, with one hand on a nuclear key all the time.
Yesterday, we left Dickison and headed back south and west but on a more rural route. If you get far enough off the beaten path you can still find open range and pastureland, where there are no fences on either side of the road. Just big lazy cattle and roadkill. We did that yesterday. We went down through Route 85 in North Dakota and then west on Route 20 to the Montana border.

We eased down into the Powder River Basin and into Devils Tower in Wyoming (which is only about an hour west of Sturgis and two hours from Deadwood if you’re on Interstate 90 headed west). Did you know Wyoming produces most of America’s coal? I say most. I think it’s about 40%. And it’s “brown coal,” with less carbon content than the anthracite coal in western Pennsylvania (the rock that burns). Most of the mining is surface mining as well, with the coal just under the surface in massive seams that stretch miles in every direction.

North Dakota got the oil (the Bakken), South Dakota got the missiles, Nebraska got the plains, Colorado got a bit of everything (especially natural gas from shale), Montana got the big sky, and Wyoming got the coal, the cowboys, and this haunted hotel I’m staying in.

I last did a trip like this in 2005 to check out the Piceance Basin in western Colorado and the “shale” story. Back then, they were looking to cook oil into shale. Gas kept getting in the way. The shale gas boom was born. There’s tons of oil and gas business out here now. Just trying to take the pulse of it and see if it’s still booming... or not. Also, it’s a good way to reconnect with family (something I mentioned in one of my earlier letters). You have a lot of time to talk on road trips. And if you have a lot to talk about, it’s a good way to do it.

Worst case scenario: I put in low ball bid for the $32 million ranch I saw advertised in one of the boutique real estate magazines in my haunted hotel room.

We head up to the Little Big Horn in a few hours before staying the night in Cody. I’ll report back in next month!

-Dan Denning
Dan snaps a picture of the landscape in the American heartland

Little Missouri Lutheran Church in Capitol, Montana
An abandoned public school district building

An American buffalo looks on