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PART II

by L. Carlos Lara

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Interview with Kevin Duffy

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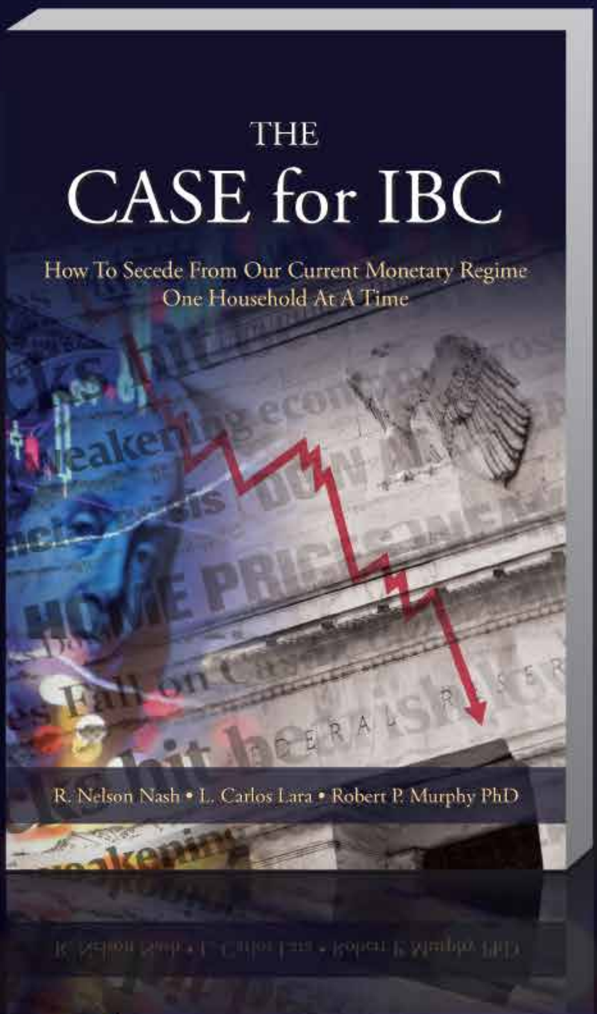

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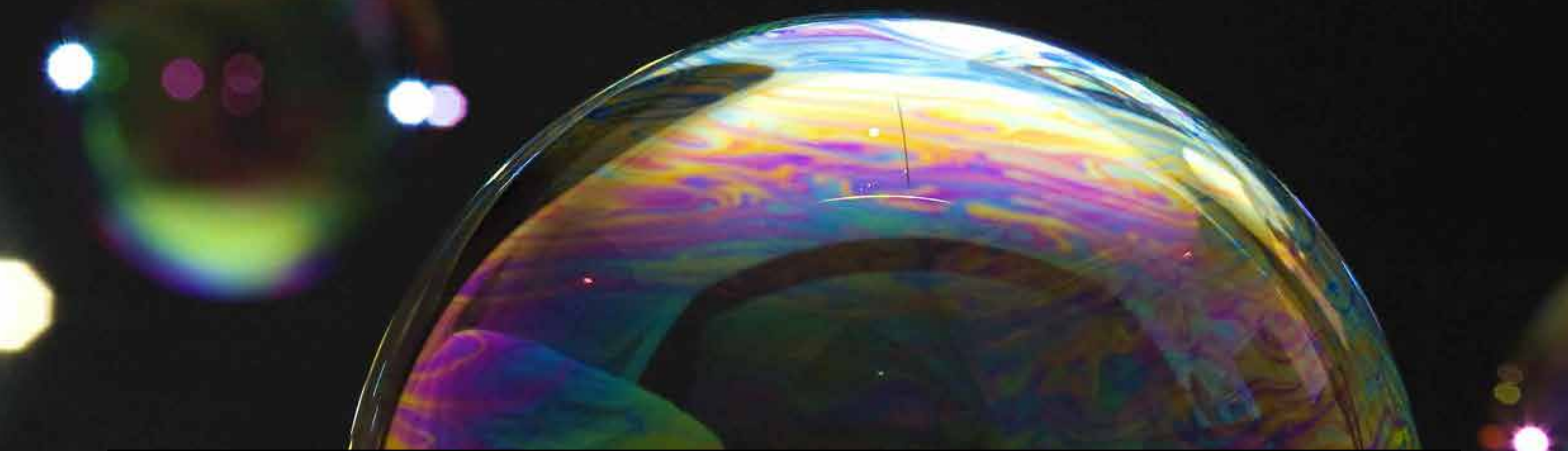
SHORTING THE 'EVERYTHING BUBBLE'

INTERVIEW WITH **KEVIN DUFFY**



Kevin Duffy is co-founder (in 2003) of Bearing Asset Management. He has more than 40 years of personal and professional investing experience, having bought his first stock at the age of 13. Bullish after the 1987 Crash, he co-founded an investment firm when pessimism was widespread. A student of Austrian economics and financial bubbles, he warned about the late 1980s Japan bubble, the late 1990s technology bubble, the 2005-07 housing and credit bubble (writing extensively for LewRockwell.com and shorting stocks like Fannie Mae, Bear Stearns, and Countrywide Financial). Duffy's current focus is on the "everything bubble," making the bear case at the 2017 Spring Grant's Conference and 2018 Finanz und Wirtschaft Forum.

[Editors' Note: Kevin Duffy was previously interviewed in the January 2011 issue of the Lara-Murphy Report.]

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

KEVIN DUFFY: CNN used to have a program called *Crossfire.* In 1989, Lew Rockwell appeared as a guest of Pat Buchanan and took the side of Exxon in the Valdez oil spill. His calm demeanor, candor, and common sense amid the environmentalist hysteria were refreshing. I wanted to learn more about the think tank he founded and this economist I never heard of named Ludwig von Mises. That led to devouring everything I could

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on Austrian economics and a trip in 1990 to the mecca: Mises University, which at the time was at Stanford University. This was a weeklong boot camp in liberty and the greatest intellectual experience of my life. I even got to meet Murray Rothbard and attend his classes and lectures!

This was early in my investing career when my contrarian instincts led me to be ultra-bearish on Japan, especially its equity and real estate markets. The speculation was wild: million-dollar golf club memberships and housewives selling mutual funds door-to-door. Austrian business cycle theory provided the missing economic piece to the puzzle. Japan's financial bubble was fomented by artificially low interest rates, compliments of the Bank of Japan. Reading Rothbard's *America's Great Depression* was a real eye-opener, as it not only explained what caused the Great Depression, but how history was repeating in Japan.

LMR: In our own experience, people in the financial sector seem much more receptive to "Austrian" (whether we use that label or not) analyses than academics are—many academics subscribe to the "efficient market hypothesis" and think nobody can see a downturn coming. Does that match your own experience, and if so, why do you think that is?

KD: I suspect you're grading on a curve. Academics are probably worse, living in their own bubbles, but investment managers aren't much better. Granted, financial types do have a strong incentive to model reality and most think they can beat the market, so there are more converts at the margin. My experience within the community of bears and non-conformists

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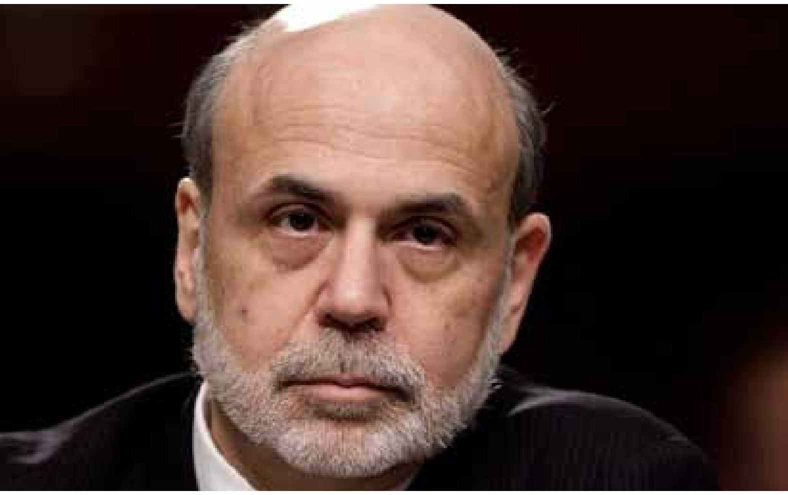
is that most either never heard of Austrian economics or know very little. I can probably count on one hand how many truly understand and integrate Austrian theory into their investment process. That's the good news. If it were popular, there wouldn't be an edge in the marketplace. As for the establishment investment firms, if you mention Mises or Rothbard they'll look at you like you have two heads. The prevailing ideology is intervention which means they won't see the bust coming.

LMR: You've been in this business for decades, and you are remarkably honest about your successes *and failures.* Can you summarize for our readers?

KD: How much time do you have? I'm a firm believer that you learn more from your mistakes. The challenge is that, in this business, those mistakes can be quite costly. Let's just say I've gotten a very expensive, but valuable, education the past eight years.

One of the biggest challenges for Austrians is negative bias. The destructive forces of government intervention are highly visible whereas the positive forces of market-driven deflation are somewhat hidden. This can lead to confirmation bias where the positives get overlooked.

I compounded this negative bias with overconfidence. Austrian economics teaches us that precise forecasting is impossible because an economy is hopelessly complex. Be humble and know your limitations. But after calling the Japan, technology, and housing bubbles, I forgot this lesson – big mistake!



"Probably the biggest variable I missed wasn't how resolutely and recklessly the world's central bankers would act, but how much market-driven deflation would take place because of the digital revolution."

LMR: We are in a similar boat, wherein through our channels, we definitely saw the 2008 financial crisis and "Great Recession" coming, even as Ben Bernanke and other gurus were assuring Americans everything was fine. On the other hand, we were very concerned about rising consumer price inflation due to multiple rounds of QE, and that hasn't happened (at least yet). How have you adjusted your worldview in light of the post-2008 experience?

KD: I've tried to maintain more balance in my analysis. As it turns out, monetary inflation can take many paths. In late 2009 I was naively convinced history would play out just like 1930. The stimulus drug would wear off in short order and the bear market would resume. Instead, the bubble reflated, but in different areas.

Probably the biggest variable I missed wasn't how resolutely and recklessly the world's central bankers would act, but how much market-driven deflation would take place because of the digital revolution. Bandwidth prices, for example, have dropped 99% since 2000. Sequencing the human genome can be done for less than $1,000, down from a billion dollars in 2000.

New technology tends to play out in waves. During the first wave, the pioneers get the arrows in the back. In the second wave, after the inevitable shakeout, the settlers get rich. There was a personal and home computer bubble in 1983, but the fortunes were made – in companies like Compaq, Dell, Microsoft, Intel, Cisco Systems – after that bubble burst. Similarly, Internet 1.0, which peaked in early 2000, ended in tears while fortunes were later made by survivors like Amazon.com and newly public companies like Google. Since 2009, price deflation provided cover for the money printers and kept the boom going longer than it would have otherwise.

LMR: Finally, you've written an interesting analysis for Marc Faber's publication, in which you discuss "Shorting the Everything Bubble." We especially liked your warning to "beware simple narratives" (reproduced below in Table 1). Can you summarize for our readers?

Table 1. Beware Simple Narratives (by Kevin Duffy)[1]

Period	**Narrative**
Late 1970s	Chronic price inflation, peak oil
Late 1980s	America's decline, Japan's rise
Late 1990s	Internet first mover advantage
Mid 2000s	Real estate always goes up, peak oil
Early 2010s	Monetary inflation will lead to price inflation
Today	Central bankers will never allow another severe bear market, all retailers will end up Amazon road-kill, gridlock is good

KD: Major inflection points share certain characteristics, such as herding, extrapolation, extremes in sentiment, and conformity. The endless repeating of simple narratives, especially by the mainstream media, is a classic sign that a turning point is near. The late 1980s are a good example. "America's decline" and Japan's rise were repeated over and over until they became accepted wisdom. In the late 1990s we were experiencing a "New Economy" in which the business cycle was repealed and first mover advantage would go to Internet startups burning cash. These narratives not only ended up being dead wrong, they created immense opportunities for contrarian investors.

"After an unprecedented seven years of near-zero interest rates fomented epic asset bubbles and debt build-ups around the world, I'm convinced the crowd has it wrong again. A bear market has already started and the next bust is not far away."

Today there are several simple narratives making the rounds. The biggest is that central bankers have it in their power to prevent a serious downturn in the economy and stock market. Keep in mind, this was a common refrain during the late 1920s boom, but of course everything is on a much greater scale today. After the mid-term elections when the Democrats took control of the House, we started hearing another bullish rationalization: "gridlock is good." After an unprecedented seven years of near-zero interest rates fomented epic asset bubbles and debt build-ups around the world, I'm convinced the crowd has it wrong again. A bear market has already started and the next bust is not far away. As the late Malcolm Forbes used to say, "conventional wisdom seldom is."

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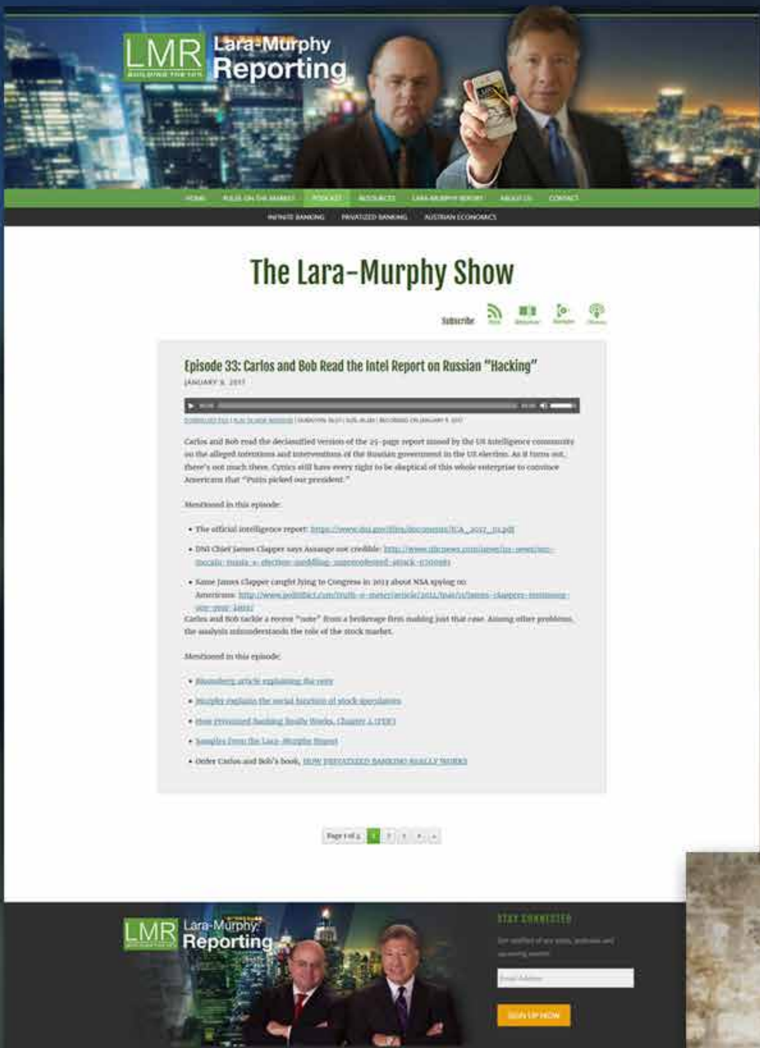
1. Table 1 adapted from Table 1 of Duffy's article in the December 2018 issue of The Gloom, Boom, & Doom Report.

Note: The economists and financial professionals interviewed in the LMR are given the freedom to express their views, without necessarily implying endorsement from the editors.



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