

Answering Your Questions

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COMING BOOK

A lot of people have inquired about “the” book. I am actually writing four books at once. The first will be on cycles and attached is a sample Chapter VI on the difference between individualism and collective behavior. I have agreed with a publisher and this should be out by the Spring. The subject of ENTROPY will be part of the Analytical Conference. I am working very hard to finish this in a few weeks. I am not sure of the title yet. The publisher tends to like flashy titles where this is a combination of the Economic Confidence Model and the Geometry of Time (unedited version).

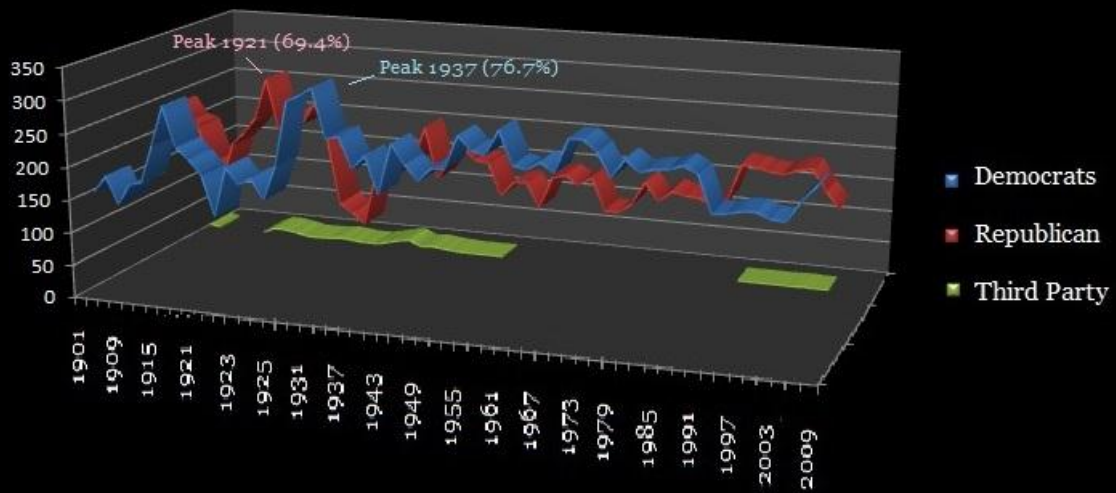
CHAPTER VI



THE COLLECTIVE vs. THE INDIVIDUAL

There has been much debate over the **Business Cycle** how to temper, control, and smooth it out, while simultaneously, arguing whether it can be predicted with any regularity. Others have stared at the wave formation trying to glean clues as to its mechanism. Others have tried to measure the wave like a tailor to try to predict its future using pattern recognition. Yet through all of this, what has been overlooked in this study is the distinction between the **collective behavior** and **individual behavior**. Some people do not want to even entertain the idea that a **Business Cycle** exists because they wrongly assume that means they are like robots stripped of all humanity and freedom of choice. That was the goal of Communism to eradicate the **Business Cycle** by eliminating the freedom of mankind stripping him of all material wealth reducing him to a destitute slave. Nonetheless, what remains grossly misunderstood about the **Business Cycle** is that the individual retains at all times the free will to be on either side of the cycle since to propel the cycle requires the creation two opposing forces.

United States House of Representatives 1901-2009



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What we are about to explore is the distinction between **collective behavior** and **individual behavior**, which on the one hand enables us to predict the future from the **collective behavior** attributes within society, yet simultaneously, we retain that inherent freedom of choice distinguishing **individual behavior**. In politics, there are left and right wing persuasions. There exists a core of believers in each camp that will **NEVER** change their mind no matter what evidence you present. However, there is a third group of independent free-thinkers who swing back and forth depending upon events and the **"mood"** of society. The existence of this third group of free-thinkers is why there is a cycle to politics as well so that neither side retains power indefinitely, except by force nor even then since most dictators eventually collapse.

Consequently, what we must also understand is while we retain that freedom of individual choice, collectively we also take on a very strange behavior that becomes quite predictable as a group. That in no way precludes individualism and free will. Nevertheless, it is a separate issue that exists yet does not clash with the subject of collective behavior because there are always two opposing forces that is the core mechanism that creates the cycle between which we bounce back and forth defined by two extremes. This mechanism creates even cycles within politics that reflects this **"mood"** of society over the course of time and circumstance.

There can be no dispute that the very nature of how the economy moves is through this continuum bouncing between these two extreme positions like a pendulum. There is a collective energy that travels like an electro-magnetic light wave contained within boundaries yet propelled by this constant pendulum of oscillation back and forth between boom and bust.

This has created waves of innovation that are indeed what Schumpeter called the force of “*Creative Destruction*” whereby with each crash, there is reform that often sets in motion the next Catastrophe. Others fail to understand this perpetual force and embark upon a quest fighting imaginary windmills assuming man has within his grasp the scepter of power to control the economy and society eliminating the **Business Cycle** by sheer will to achieve that Hollywood goal of living happily ever after. But then again, this goal has never been accomplished even just once since communism collapsed unable to eliminate the **Business Cycle**. This quest has cost countless millions of lives in this battle between **capitalism** and **communism**. Indeed, the former Chairman of the Federal Reserve during the 1970s, Arthur Burns, expressed it best remarking that for well over a century **Business Cycles** have:

“persisted through vast economic and social changes; they have withstood countless experiments in industry, agriculture, banking, industrial relations, and public policy; they have confounded forecasters without number, belied repeated prophecies of a ‘new era of prosperity’ and outlived repeated forebodings of ‘chronic depression’”
(Burns, 1947).

This desire for absolute perfection and **uniformity** has created the storm of revolution throughout history and single handedly inflicted much pain, suffering and death upon mankind, destroying human rights, and deprived us of our very essence of humanity – freedom itself. Communism led to the slaughter of millions of people all in this quest to eliminate the **Business Cycle** which is created to a large part by humanity itself. Human rights are given to man by God, yet it is always man through his desire to dominate and rule others, that perpetually seeks to destroy those rights to further the scepter or tyrannical power regardless of the form of government.

This presumption that government possess this scepter of power and the right to alter the lives of men in a mission to eliminate the **Business Cycle** arguing it is not “*fair*” to be subject to such boom and bust cycles, is as realistic as trying to declare that no creature shall prey upon another for food. There are some things that are simply part of nature and form the grand scheme of how the whole functions. Man is always enticed to surrender his human rights to liberty to those claiming to have a divine right of power in return for hollow promises of eliminating the **Business Cycle** to create the perfect world.

Instead to trying to explore history without a predetermined bias, far too many have sought only to justify what they believe by recasting the events in their own light. Unfortunately, the practice of economics has been plagued by this presumption of a mythical divine scepter of power to manage the economy and thus the **Business Cycle** resulting in tempering and controlling the behavior of mankind. To eliminate the **Business Cycle**, we must surrender our humanity. This idea of the existence of such a scepter of power has prevented the field of

economics from rising to a true science trapped in a politically corrupt world of bias, prejudice and the sheer desire to dictate the behavior of mankind.

What we must understand is that just as it takes two-to-tango, it takes at the very least, two primary opposing forces to create mechanism by which energy can move even through society by creating two primary political points of view that motivate people to act. This same constructive progressive movement between two extremes within economy creates the **Business Cycle** in what Schumpeter called the force of "*Creative Destruction*" merged with Smith's *Invisible Hand*. If there is **ANYTHING** that we can establish as the first **LAW of Economics**, there will never be a nice steady linear progress over decades and centuries without the **Business Cycle** and its booms and busts. To eliminate the **Business Cycle** is to destroy humanity itself by attacking our character and freedom. With every single event or iteration of the **Business Cycle**, we advance society creating progress through this force of "*Creative Destruction*" as we seek to innovate and reshape our surroundings always making changes with each cycle event. Collective participation creates **Waves of Innovation** constructed from a synergy of ideas incapable of emerging from government, central planning or a single individual.

In financial markets, we call it these two opposing extreme forces the bulls and the bears. In politics we call it the left and the right. There are always two opposing forces such as male and female, good and evil, and as the Chinese express it, yin and yang. This is the engine of life. It is how everything moves and progresses. Within a market, there is the seller and the buyer and this is simply the nature of all things. There will never be agreement in politics or in economics where 100% of the people share the same idea. This is what is called the ultimate disaster in climate known as the *White Earth Effect*. If the earth ever had its continents covered by snow and whose oceans were covered by ice, this condition would reflect so much sun light that the earth would remain a frozen wasteland unable to absorb heat. If you have ever been skiing you will know that while you are in the cold, the reflection of the sun light from the white snow makes you hot. If 100% of the people ever agreed, this would be the equivalent of the *White Earth Effect* in economics. The **Business Cycle** would die, but so would innovation and society. Without the motivation to react to some event, "*Creative Destruction*" of Schumpeter, we would stagnate and Smith's *Invisible Hand* would die. The glass is simply perpetually half full to some and half empty to others. It is the co-existence of two opposing forces that creates the fuel behind the cyclical movement in all things right down to electricity (positive and negative) or to magnetism and gravity. It is this cyclical force that propels all forms of energy through all forms of mediums including humanity by inspiring us to choose sides.

One of the **interesting** mysteries is that there is a hard wiring so to speak in human nature that causes us to act as a collective. There is a famous study by Stanley Milgram (1933-1984) where an assistant stepped out on a busy street in New York City and stared upward into the sky. At first, the people just walked around him and did not bother to look up. However, when four more researchers were added forming a small collective group now staring into the sky, suddenly people stopped and joined in to see what was happening up there, S. Milgram, L. Bickman, and L. Berkowitz (1969). Let there be an accident and cars will slow down to take a look. The whole line of traffic is brought to a crawl and when you arrive at that spot, instinctively you too look to see what is going on.

This collective behavior is a field known as **Social Psychology**. Surprisingly, the majority of people are unable to report even remotely accurate factors that cause certain collective behavior as demonstrated by R. Nisbett and T. Wilson (1977); see also **Psychological Review**, 84:231-59. For whatever reason, we as a species in fact are the same as animals. We form flocks or herds and join groups, clubs, parties, or associations of one form or another. This is the very reason why we even have civilization – the coming together of people to form a society.

It appears that we are hard-wired to form collective behavior that is not always easy to comprehend for it takes place at the subconscious level. Thus, our collective herding instincts become persuasive as a motivating factor. We may not follow just one person, but when the group moves, we follow instinctively. This is a separate field of study that reveals we are in fact social animals as Aristotle suggested. This type of collective behavior exists and explains why people will tend to follow crowds, see **The Wisdom of Crowds**, J. Surowiecki (2005). Just as we will associate some behaviors automatically with particular situations such as being silent in a library, **Journal of Personality and Social Psychology**, 84:18-28, we will all panic if it appears everyone else is!

When we look at this subject of the **Business Cycle** and economy, we are in the field of **Social Psychology** that is very much distinct from understanding the motivation of a particular individual. The rise and fall of the **Business Cycle** and economy is predicated upon group behavior driven between these two extremes of opposite views. It can be plotted and measured with accuracy that is not possible for a particular individual. We retain the ability to reason and that means we retain the ability to agree or disagree with the group and even switch sides as takes place in politics explaining why neither the Republicans nor Democrats retain power forever. Collectively, it would be the **White Earth Effect** and the destruction of society. Society will naturally bifurcate into two primary groups. There is typically that third group we may call "**swing-voters**" or "**independents**" that refuse to conform with either group entirely retaining that spark of humanity and free thinking. For you see, with time, each group constantly shifts and eventually switch places – a pole shift as with the sun every 11 years. The

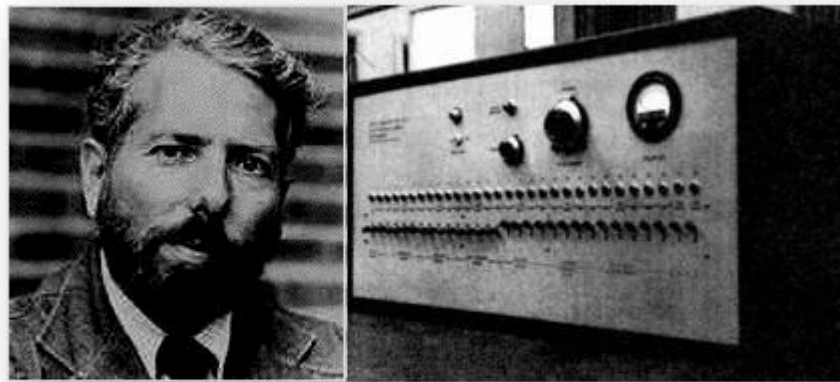
Democrats were the slave owners during the 19th century and the northerners, Republicans led by Abraham Lincoln. Today, it is the Democrats who claim the mantle of the blacks and the Republicans are seen as the party of the rich. With time, the two parties switch positions, yet remain on opposite sides.

This third group in the political process appears to be composed of up to 20% of the general population on an average day. However, when discontent emerges more and more defectors from Republican and Democrats become independents. When conditions are right, the defections become significant and now we have a crowd that may even reach the majority allowing a third party to emerge. When that takes place, it becomes possible for dramatic political change. Yet this is all part of the mechanism that forms a **Complex Adaptive Dynamic Network** behind the **Business Cycle**.

Just as Adam Smith explained that there is an **Invisible Hand** that emerges from the collective synergy of the group where each individual in pursuing his own self-interest creates society, we must respect this dynamic force and group behavior separate and apart from the individual. It is this pursuit of self-interest that creates everything. Marxists will always point to just the material effects. However, it is this self-interest that creates careers for it is the individual who decides he wants to be a doctor, engineer, or whatever as opposed to being told to do something because society is short of trash collectors right now. The **Invisible Hand** in the essence of **Liberty** – the freedom to be what you want to be.

Unfortunately, there are those who want to be prosecutors to even scores for wrongs they feel they suffered or dictatorial politicians to feel they have a right to prevent behavior they disapprove of. They often said of Puritans who came to America on the Mayflower that they could not sleep at night worrying that someone was having a good time that offended them. There never was such a general passion for dramatic entertainments as during the Elizabethan (1558-1603) period. Shakespeare's plays were the TV entertainment of the time. 1629 was the first year in which a female performer was seen in the English theater, but she was not tolerated and forced off the stage as the audience threw things at her. When the Puritans gained control after defeating Charles I in the First Civil War (1642–1645), on the 6th of September, 1642, the theaters were closed by ordinance, it being considered not seemly to indulge in any kind of diversions or amusements in such troublous times. In 1647 another and more imperative order was issued, in consequence of certain infractions of the previous one, threatening to imprison and punish as rogues all who broke its enactments. The Puritans outlawed kissing your wife in public as well as all sport and prohibited celebrating Christmas. Religion is always an excuse for one group (majority at that moment) to oppress the minority. Hence the perpetual clash between Protestant and Catholics in Britain and Northern Ireland.

This entire Marxist driven agenda has been all about material wealth that taps into self-interest of individuals who form groups based upon material jealousy creating class warfare. Marxism/Socialism has tapped into that self-interest of the people in claiming they will take from the rich to give to the poor who are naturally greater in number. This is the offering of giving something for nothing. This rhetoric taps into that corrupt human nature on the dark side that is described in one of the Biblical Ten Commandments - coveting thy neighbor's goods. Government always covet everyone's goods for there are constantly desperate to seize money to maintain their scepter of power.



Stanley Milgram (1933-1984), Obedience to Authority



Stanley Milgram's Experiment

One of the most fascinating experiments into human behavior was that conducted by Stanley Milgram in 1965 that exposed what has come to be known as the ***Obedience to Authority***. that set up an experiment at Yale where average people were told to inflict an electric shock upon another person for answering a question incorrectly. The person being shocked (victim) was an actor who was told to kick the wall, demand to be released, beg the person inflicting the

electric shocks to help him, and at a point he would shout that he would not answer the questions any longer. To the surprise of everyone, average people inflicted torture with 65% subjecting the victim to shocks at the maximum of 450 volts despite the screams (Stanley Milgram (1933-1984), Obedience to Authority).

To a large extent, this experiment was inspired by the Nazi soldiers who claimed they were only following orders. Many argued this was a flaw in the German culture. Milgram exposed perhaps the most truly disturbing aspect of our collective behavior ever uncovered. The overwhelming majority of people inflicted what they thought were searing electric shocks complying with what they were told by authority. Some implored the researcher to let them stop. But the researcher refused. Yet they continued. Some trembled. Others perspired. There were some who dug their fingernails into their own flesh or bit their lips until they drew their own blood. Still they continued to torture the victim. One observer wrote:

I observed a mature and initially poised businessman enter the laboratory smiling and confident. Within twenty minutes he was reduced to twitching, stuttering wreck who was rapidly approaching a point of nervous collapse. He constantly pulled his earlobe and twisted his hands. At one point he pushed his fist into his forehead and muttered: 'Oh, God, let's stop it.' And yet he continued to respond to every word of the experimenter and obeyed to the end.

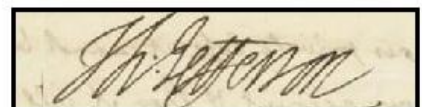
The Milgram experiments were disturbing and enlightening. A large portion of people will often obey government blindly. Whatever they say about anything or anyone, they just accept as a mindless drone. Yet at some point, the pendulum will swing and the majority will then reject the government as authority and revolution is born. Thomas Jefferson (1743-1826) understood the cycle between two extremes. He wrote in his famous letter

"What country before ever existed a century & a half without a rebellion? & what country can preserve it's liberties if their rulers are not warned from time to time that their people preserve the spirit of resistance? Let them take arms. The remedy is to set them right as to facts, pardon & pacify them. What signify a few lives lost in a century or two? The tree of liberty must be refreshed from time to time with the blood of patriots & tyrants. It is it's natural manure."

*Letter From Thomas Jefferson to William Smith, Paris,
November 13, 1787*



Thomas Jefferson (1743-1826)



What Jefferson is explaining is his own observations of history and the existence of this cyclical aspect to society. Indeed, there is no empire, nation, or city state that has survived the fate of time and circumstance. They are all simply buried in a common grave. There is a cycle of life to all societies. When they collapse, it is the Blink-of-an-Eye just as Communism collapsed in 1989 that appeared to emerge out of nowhere. Many attributed the collapse to modern communications. However, in 509BC, Rome overthrew its Tarquin king giving birth to the Roman Republic upon which our modern societies are copied. Within one year, Athens gave birth also to Democracy in 508BC. The timing was about the same. Even the American Revolution that once again overthrew monarchy was followed by the French Revolution and republics were once again in fashion.

Hegel's **Dialectical Scheme** also has grasped this concept of the **Business Cycle** whereby the progress of history and thinking of mankind emerge from thesis to antithesis and hence this merges into a higher and richer synthesis. Hegel indeed applied his **Dialectical Scheme** in detail to religion, politics, logic, aesthetics, history and ethics. These two opposing forces that coexist at all times in everything are the true driving force behind the entire cyclical nature of events. Hegel's views that what emerges being a higher synthesis is a different way of explaining the "**Creative Destruction**" force of Schumpeter.

A common example of Hegel's **Dialectical Scheme** is the subject of **LIBERTY**. A savage has total **LIBERTY** insofar as he can do as he likes, provided he is also just a nomad. He comes to surrender part of the **LIBERTY** in return for its opposite, to live in a collective society under rules. The synthesis emerges insofar as the savage now has greater **LIBERTY** in a collective society. While this example may in fact confuse the evolution of society at one level, it does not deal with how that collective state then collapses or why. Eventually, the individual is asked to give up more and more of their **LIBERTY** for the state is never satisfied with its present power. At some point, that denial of **LIBERTY** is no longer acceptable and the alternative becomes the dissolution of the state (revolution).



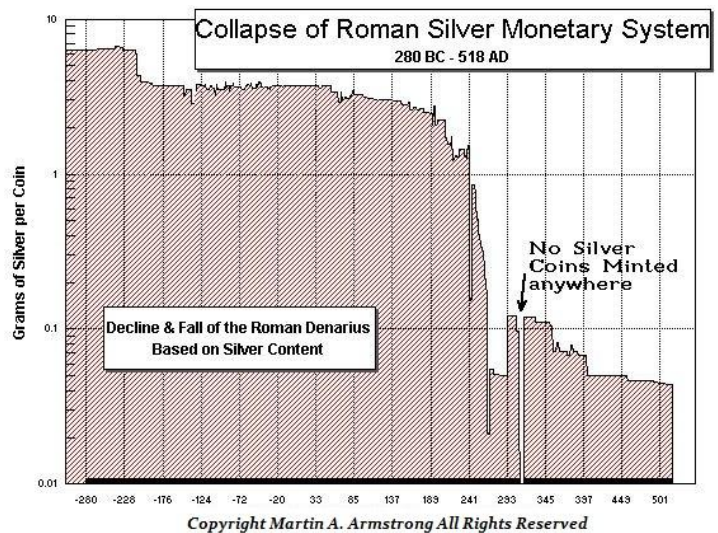
George Wilhelm Friedrich Hegel (1770-1831)

The Rise & Fall of Civilization



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Hegel, correctly saw the swing between two opposites that was the driving force behind the cyclical nature of history and the **Business Cycle**. Yet there is no permanent state of synthesis at the macro level in each instance. Eventually Rome collapsed for it lost the respect of the people by removing their **LIBERTY**. As the state loses power, it becomes more aggressive and Draconian out of self-interest (**Invisible Hand**) desperate to retain power hunting down the wealth of its people for its own use. Once there was no longer a benefit to living within a collective society, people historically migrated. This is what the Romans call "**suburbium**" the flight from cities because of taxes. We can see here the collapse of the Roman Monetary System during the 3rd century. The silver content fell to about 1/50th of its prior value all because Government was desperate to keep funding itself by debasing the currency to create more coins with less silver. Modern government today are in the same fiscal crisis desperate for money.



This is the essence of **CONFIDENCE** that drives the very core economic engine which powers the **Business Cycle** and ultimately civilization. To a large extent, there is also generational aspect to this cycle creating long-waves of about 52 years in duration whereby one generation seeks change from the status quo of the previous. This is part of the "**Creative Destruction**" force of Schumpeter. In other words, this degree of **CONFIDENCE** will generally reside with the

government thanks to this **Obedience to Authority** discovery of Milgram for a period of time. This allows Communism to thrive and dictators to rule as well as “representative” elected politicians to increase taxes in their own political self-interest but only up to a point. Finally, that Invisible Hand appears and in the Blink-of-an-Eye, the whole thing comes crashing down. This is the very nature of the **Business Cycle** and while government will always abuse its powers to further its political self-interests, the pendulum will swing backward away from government that enjoys Milgram’s **Obedience to Authority** effect and move in the opposite direction back toward private self-interest of the individual to restore once again his Liberty as Jefferson noted.

This behavioral system is the driving force behind market activity as well. With every stock market crash there is the inevitable investigation to hunt down the mythical monster short position that overpower the market and involuntarily compelled its decline. As the theory goes, someone borrowed massive amount of stock and sold it creating the crash. Of course, this brain-dead idea has driven every investigation since the 1907 Crash. Never once has this mythical creature been discovered. Like the Greek Pan of the Forest half man and half animal, we too have this mythical idea of the huge short-player. Nobody has ever seen him and no investigation has ever discovered even his footprints.

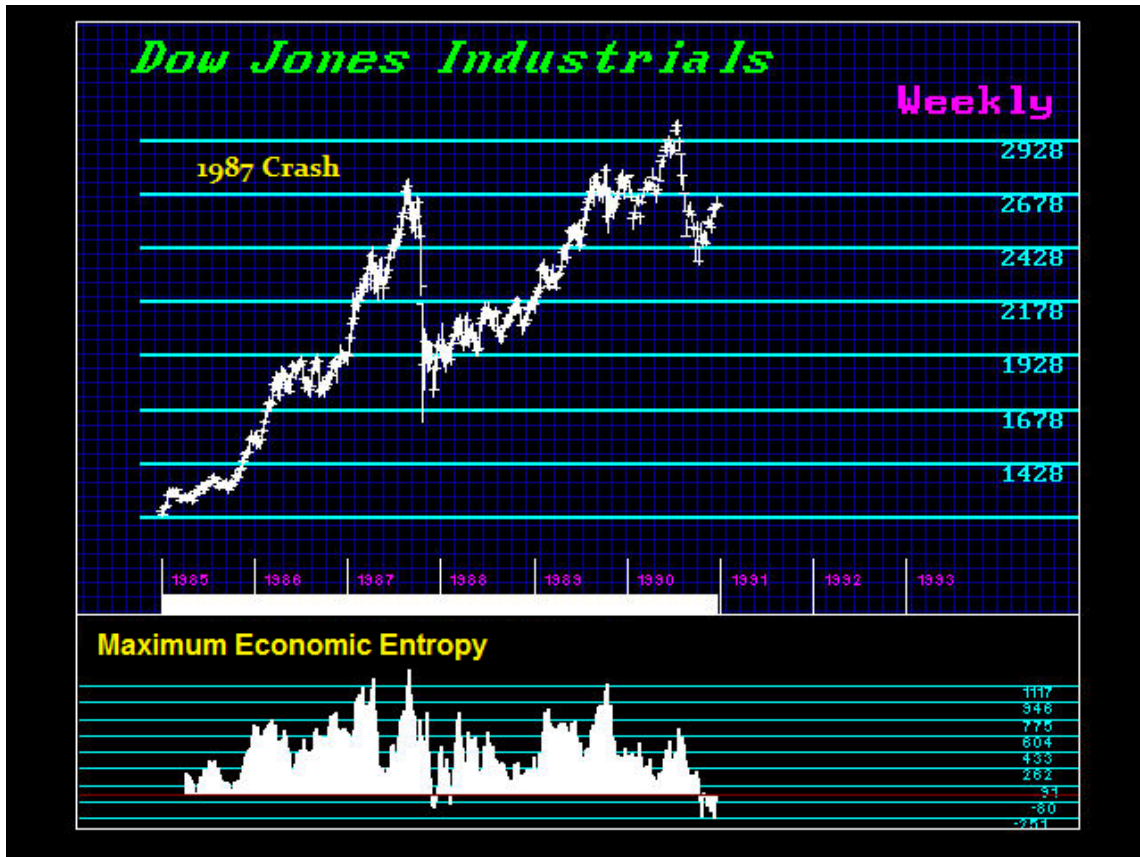
Again, the answer lies in the Collective Behavior of Man. A market crash, like that of 1987, takes place not based upon anything other than an imbalance between the two opposite groups – bulls and bears. When the majority ends up on one side this is the moment when the slightest amount of pressure will cause the greatest amount of change. In other words, if we define the market from the Laws of Thermodynamics that sit on top of all other laws, we can get a better sense of this oscillation between **ORDER** and **DISORDER** as being the two opposing forces. The measure of disorder is known as “**entropy**” which refers to the energy in a system that is not available for work and is thus a dissipated potential. Let us redefine this term with respect to markets. “**Economic Entropy**” is a term I use to express the maximum point of expended energy in the direction of the trend. Thus, in a bull market, reaching the point of **Maximum Economic Entropy** warns of a potential crash. It represents everyone who is already long who are counting their profits, but have expended all of their capital and thus have dissipated their buying support. When the market reaches this point of **Maximum Economic Entropy**, then it represents the greatest potential for **DISORDER**. This now represents the



greatest reservoir for potential sellers because the **ONLY** action available to this group is to move toward the opposite pole like a pendulum, which is to now sell. The mythical massive short-seller, who has never been found, is actually this reservoir of dissipated buying power. The amount of **NEW** or **FRESH** buyers available to cause the market to continue its advance diminishes with the growing number of longs who have already expended their buying power reaching the **Maximum Economic Entropy**. As the potential new buyers diminish adding to the group of longs who have expended their capital, the point of **Maximum Economic Entropy** is then reached. Now, the **SLIGHTEST** amount of selling pressure can cause the **GREATEST** amount of change – **PANIC!**



It is **NOT** the presence of a massive mythical short-position that causes the **PAINC**. Instead, reaching the **Maximum Economic Entropy** means we now have the **GREATEST** resource of sellers. If we have reached a point where more than 85% of everyone who ever thought of buying the stock market has already bought, then scare this group and you have the **GREATEST** amount of potential change whereby they begin to run trying to sell and it is the **LACK** of sufficient short-players that causes the decline for the **ONLY** person will to buy in a **PANIC** is a short-player taking profit.



Pictured here is the Dow Jones Industrials on a weekly basis from 1985 into the end of 1990. Here is displayed the **Maximum Economic Entropy** showing that during the 1987 Crash that took place in October of that year, this indicator that measures the advances and declines counter balanced against each other, illustrates how once the point of **Maximum Economic Entropy** was reached, the crash caused this indicator to turn negative. This took place also during the fall Crash of 1990. This is by no means a moving average nor a stochastic indicator. This is a measure of the two opposing forces within a market on an accumulative basis.

The collective behavior of mankind in the form of market activity or economic activity is never some nice and neat linear progression. It is this constant movement back and forth like the waves in an ocean or a sidwinding snake – balance and counter-balance. This indicator illustrates the danger of government intervention. The typical move is to prevent short-selling. This, however, further diminishes the opposite opposing force. It is the short-player who is the **ONLY** one that has the courage to **BUY** during a panic decline. It is the short-player that provides the vital underlying support. Outlawing the short positions is the equivalent of creating communism – it is not only the antithesis of a free market, it is trying to eliminate the **Business Cycle** and thus it is delaying the recovery. This is why Japan moved into a massive economic decline. They discouraged short-selling to the point they asked at the very top the largest institutional investors not to hedge for that would cause the market to decline. This left

the **Maximum Economic Entropy** in virtually a maximum position of people who were long, had no capital to buy more, and desperate to sell just to break-even. Thus, the market slowly declined into what may prove to be a 26 year depression. Had the government left the market alone, the price action would have forced the selling of portfolios and the decline would have been similar to that of the US Great Depression when from top to bottom, 1929 to 1932, the market fell by almost 90%, but the point of **Maximum Economic Entropy** flipped to now the maximum number of nonparticipants who had no thought of buying anything at the low.

Most people have acknowledged that there is a **Business Cycle** including former Chairman of the Federal Reserve Paul A. Volker who wrote in 1978, *Rediscovery of the Business Cycle*. Indeed, most economic statistics are "**Seasonally Adjusted**" meaning they are attempting to remove the cyclical movement within the economy. This is also why they also show year over year comparisons because there are "**seasonal**" aspects to the economy that are impacted by



weather that includes everything from crop production affecting food prices to vacations and Christmas that is always the peak in retail merchandising. Yet at the same time, we must understand this inherent trait that we seem to share with animals – the tendency to group together. It is this collective behavior that is defined by the **Business Cycle**. By no means does it predetermine the future of an individual, for simultaneously, we retain the freedom to choose which of the two main groups we will join.

Everything is driven by these two opposing forces be it markets or even politics. A market crash is no different than a political revolution. Both represent reaching the point of **Maximum Economic Entropy**. In the political world, it unfolds as a **REVOLUTION** that the politicians do not see coming yet produces sweeping change as we saw in 1989 in China and Russia. It was the same force that brought the slogan "**no taxation without representation**" that was the battle cry in the American Revolution and manifested later as the French Revolution. This same force drives the economy and not just the rise and fall of nations, but of markets as well. For you see, there are basic laws that apply to everything. The **Law of Thermodynamics** sits on top of all other laws in Physics. Only the sublime ignorant or the bread-dead greed of self-interest lead to the state of denial that the markets are driven by order and are not some random walk through unpredictable nonsense that justifies government intervention to manipulate our lives for their personal political gain.