

INVESTMENT POLICY MEMO

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MAY YOU LIVE IN INTERESTING TIMES

Although there have been a few hopeful straws in the wind recently, investors who grasp them may be in peril still. The forces of depression remain fierce and relentless. While monetary and fiscal economic stimuli continue to proliferate in number and size, their ultimate effectiveness is yet unproven in the present or based on any analogy from the past. As we mentioned in last July's memo, we are in the midst of a great, global experiment whose outcome cannot be anticipated with any confidence because it has not previously been clearly imagined, let alone experienced.

Students of economic history, including Milton Friedman and Ben Bernanke have argued that if only the Federal Reserve and other central banks had used their powers to prevent bank failures and the destruction of money, previous severe depressions would have been essentially avoided. Except for the disastrous decision to allow the failure of Lehman Brothers, this advice has been followed this time in every country. John Maynard Keynes and a world full of economists after him, have argued that spending more government money or cutting government taxes can also subdue and terminate economic collapses. Now governments -- especially the U.S. government -- are acting like (only occasionally reluctant) Keynesians.

The question that neither the Keynesians nor the monetarists ever addressed with any rigor is how effective their remedies would be in an environment of unwinding excessive debt and speculation, which is exactly our situation today as it was in the 1930's. Once it is generally agreed, as it now is, that vigorous policy responses are urgently necessary, there remains the problem of how to choose appropriate responses from an overwhelmingly large menu. Arguably, so far, the Obama administration is doing this as poorly as its predecessor.

The stimulus package is less than half the size it should be; and its effectiveness is diluted by a flood of politics as usual: subsidies for the auto industry (on top of the wasteful bailout); tax credits for campaign contributing industries which cannot possibly have any effect until after we already have a recovery; subsidies for investment which are known to be ineffective, especially in an environment of collapsing demand; one time cash rebates which are likely to be used to pay off debts or to be saved as they were last year; a buy-America provision which flies in the face of common sense for a country whose best hope for recovery is through stronger export growth and defies the advice America has given to the rest of the world, sometimes at the point of a gun. There are many more examples which we lack time to mention.

The prospects for an improvement in the effectiveness of interventions in the banking system and credit markets are also dim. The Obama administration and the Federal Reserve remain obsessively fearful of actually owning the banks they are busy bailing out of their follies. It is remarkable that already under the Paulson plan, which has only been half implemented and which was not all used for capital injections into banks, the government has advanced more money to the banks than the entire market value of all the common stock of all the banks in America. On top of this, they have guaranteed a large multiple of this sum: more than a trillion dollars of bad assets held on banks' balance sheets and bonds sold by banks to outside investors. Yet, we the taxpayers, whose money has been thus disposed with little transparency, democratic process or thoughtful debate, have received no equity ownership in those banks, nor had the opportunity to place a single director on any of their boards.

The continuation of the fear of “nationalizing” the banks or appearing to embrace “socialism” should not be surprising to anyone who has listened to Obama’s speeches or looked at his record with a clear head. He has consistently favored private initiatives over public ones. And in the process, as a legislator, he has left at least a reasonable suspicion that he also is susceptible to the pervasive and corrosive influence of money in our politics. It is a political myth that he raised and spent a record amount on his campaign through small contributions over the Internet. He raised more than any previous candidate from corporate America and especially from Wall Street, developers and home builders. The team of economic advisers he has selected, mostly veterans of the Clinton administration, has a similar pro-business record. A notable exception is a holdover from the Bush Administration: Sheila Bair, Chairman of the Federal Deposit Insurance Corporation, one of the few in government to have proposed sufficiently ambitious interventions throughout the crisis and who championed homeowners over banks.

Whatever policies are implemented, it is clear that they need to be internationally coordinated in our global economy. If one nation extends its guarantee of bank deposits further than others, deposits will flow from other countries into that nation’s banks, causing a big problem everywhere else. If fiscal stimulus is the solution then it must be practiced by all large countries in the world. So far the Obama administration has devoted little but brief lip service to this idea. And the new Secretary of the Treasury, Timothy Geithner, managed to issue a sharper criticism of China’s “currency manipulation” than ever came from the Bush administration before he was even confirmed. This may have been a throwaway to labor union supporters with no intention of following through, or a gaffe of the sort that Hank Paulson made frequently, or a serious new policy statement. None of these interpretations is comforting and the last is a bit frightening. Floating exchange rates as championed by the U.S. government have been part of the speculative excess of recent decades and a big part of numerous financial crises. China has done remarkably well maintaining a stable currency in the bubbling sea of currency speculation so that investors and international traders could have more confidence in the long-term consequences of their actions. The world would be better off learning currency manipulation from the Chinese than forcing them to copy us.

All of this is not to say that we are doomed to failure because of inadequate, inefficient or corrupt government policies. It is only to be expected that government policies respond effectively only after events have exerted painful force on policy makers. We have already seen this repeatedly since August, 2007. The programs being proposed are still large, at least compared to the New Deal in the 1930's or the War on Poverty in the 1960's. We simply do not know how well they might work or how quickly they might be improved in response to further economic decline because we have no comparable previous experience and no convincing way to apply logic to a forecast.

Our view is that we are most likely to experience a serious recession lasting another two years or much longer. But of course, since the future is currently much more difficult to predict than normal, we must allow for the possibility that all these government programs will succeed despite their flaws. The essence of our investment strategy is to keep a very large portion of portfolios in long-term, very high quality bonds. In a prolonged recession or depression these bonds will do well as investors flee to safety and interest rates fall along with economic activity and inflation. Total returns to bondholders could easily be greater than ten percent for a year or two. We also aim to keep a much smaller portion of portfolios still in common stocks. If the economy does rebound before the end of this year, stocks are likely to explode, rising by fifty percent or even doubling. So a small investment in stocks will go a long way toward a good return for portfolios, even if bonds contribute little or nothing. In a longer period of economic decline, stocks are likely to continue their dismal performance of the past year and a half. Owning more bonds than stocks could erase these losses.

As always we think it is more important to avoid losses in the bad outcomes than to maximize profits in the best outcomes. A belated Happy New Year to all in this most interesting and anxious time.