

INVESTMENT POLICY MEMO

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BEAT THE DEVIL

The rise from the ashes of the American and world economies has been slow and is likely to continue to be slow, at least in the world's highest income countries. As with all previous recoveries from major financial crises, there is a serious drag from large debts remaining to be paid and depressed prices of real estate and common stocks compared with the end of the boom. Just as getting more into debt enabled us to live beyond our means, the long slow process of paying off that debt, which has barely begun, ensures that we will live well below our means as long as it takes to reduce debt to a more comfortable level. The consequences will be slow growth for the American economy and the world economy for a long time. For example, at the average savings rate since the recovery began last July, it will take approximately ten years to restore the ratio of debt to income that prevailed in the mid-1990's, let alone the lower ratios for all the years before.

After the recovery began there seemed to be a possibility, for a while at least, that the unprecedentedly large and swift interventions around the world would lead to a stronger rebound than previous aftermaths of financial crises. For much of last year we were optimistic that things could be different this time. We took comfort from the cooperation across nations, regions, political parties and ideologies that produced the initial effective responses to the credit crisis. Over the last five months our optimism has evaporated. On the one hand, virtually all the modest economic growth that has occurred in the United States and most of the world has been a direct result of government programs. The implication is that to keep the economy from slowing, let alone to increase growth, there must be a continuation or an increase in the level of government support and stimulus.

That continuation of government assistance has been called into question across most of the world. In last November's elections voters in numerous states elected Republicans to replace incumbent Democrats, including two sitting governors who had previously won with large majorities. And in January, Massachusetts voters elected a maverick Republican to complete the term of Senator Ted Kennedy, thus depriving the Democrats of their 60 vote, filibuster-proof, super-majority. A common thread in these political shifts is that both the Bush-Paulson TARP and the Obama-Summers Stimulus were too small and too inefficiently designed to prevent further declines in the economy and increases in unemployment. This made it easy for opponents to claim and voters to believe that they simply had not worked, while the truth is they worked as well as one might have expected to prevent a horrible depression although they were clearly not properly designed or scaled to end the recession. In addition voters saw with perfect clarity that the inadequate size and improper design of these programs was only the symptom of their obvious intent to aid investment bankers and wealthy campaign contributors at the expense of the unemployed and homeowners unable to pay their mortgages.

Voters also saw clearly that neither Republicans nor Democrats were interested in punishing the criminal behavior of bankers, as was done after the savings and loan crisis of the early 1990's when over 1,000 people were sent to jail, and of course after the Great Depression. The Republicans, unlike their Democratic opponents, were at least angry at somebody about what has happened to millions of people. If the Democrats couldn't be angry at the bankers, then the Republicans being angry at the incumbent Democrats was the next best thing. The net result of all this is that additional effective government action from the White House, the Congress or the Federal Reserve is now unlikely.

The same increase in both antipathy to economic stimulus and political deadlock is recently apparent across the world. In Greece, which is still in a severe recession, there appears to be no choice more attractive than decreasing government spending for several years by enough to guarantee continued recession with sharp increases in economic distress and unemployment. Portugal, Spain, Italy, much of Eastern Europe, some Scandinavian countries in addition to Iceland, and even the United Kingdom, are not far from similar disastrous crises. The European Monetary Union is convulsed in a conflict among its members for which there is no procedure of reconciliation. Everywhere else, central banks and central governments are vowing to begin reducing monetary and fiscal stimulus at the earliest hint of inflation or sustained economic growth, however modest.

The trouble with governments borrowing less and spending less is that most households and businesses want to do exactly the same thing. People and corporations have borrowed more than they can afford over the past ten to thirty years. Now they need to pay it back. Governments had also borrowed a great deal before the financial crisis even began. But if everybody tries to pay back debt at the same time by spending less, the result would be an economic black hole comparable to the Great Depression. Incomes would fall, demand for everything would fall, prices of houses, common stocks, commercial buildings and factories would fall, causing their owners to sell them in order to pay off mortgage and other debts that would not fall, forcing property prices even lower leading to even more foreclosures and other forced sales. One solution to this problem would be to renegotiate or cancel unviable debts, leaving as many homeowners and businesses as possible still in possession of their property. This solution is fiercely opposed by the banks, the President, the Republicans, and most Democrats in Congress.

The remaining solution is for governments to increase their borrowing and spending as a replacement for the contracting spending and borrowing of the private sector. That solution is now flying out the window as well. Governments, which may have already borrowed too much, should nevertheless now borrow even more. Since the tax revolts of the Reagan days the component states of the U.S.A. have done their best to destroy their ability to increase spending in a crisis: First by imposing severe limits on property taxes, which are most stable in downturns as well as less regressive in their effects on rich and poor. Second by spending their rainy day funds when it was only cloudy, borrowing against future revenues (notably from the huge tobacco settlement) and privatizing revenue earners like turnpikes by selling them for cash up front to increase current spending and by spending the capital gains tax bonanzas from various bubbles as if they were recurrent income. In effect much of what should have been today's income has already been spent.

The third failure of the states to rectify their ineffective tax systems was refusing to broaden the base of the sales tax from the goods and personal services that made up nearly all of the economy a century ago to the services that now constitute about two-thirds of all purchases. So, the pet shop owner dutifully charges and collects about a dollar of sales tax on a bag of dog food and a squeaky toy while lawyers, bankers (and investment advisors) successfully resist the inconvenience of having to do the same on the substantially larger bills sent to their clients. (For more on the fiscal crisis of the states [see recent issues](#) of the blog *Econamici*, written by Polly Cleveland.) And the states attempt to balance their budgets by cutting welfare and unemployment recipients, closing schools and libraries, neglecting parks, ignoring long deteriorated bridges and dams that threaten grave damage, and attempting to freeze salaries of public employees or reduce them with mandatory additional days off; but most of all, by flocking first to establish themselves in the lottery business and now in the casino business. While the rich insist vehemently that they cannot afford to pay more taxes, the poor, the poorly educated and the addicted, happily or compulsively lose money gambling and the states take their share.

Fewer schools and more prisons seem to be the signposts for the future of our youth. They are bad auguries for our own futures as well. The real problem with Social Security and Medicare is not how they will be financed but who will produce the clothes and food and healthcare services, drive the buses and operate the rest of the economy required by aging baby boomers if the younger generations, already less numerous, become less productive as well for lack of education or for being imprisoned? Suppose these “entitlement” programs were fully funded, whatever that might mean, but that there were no people left in the workforce, how would all that money buy the goods and services required by the retired and the imprisoned? It would clearly be a better solution to use money now to keep people out of jail, improve education and increase the quality and vitality of our public and community spheres rather than “invest” it -- only in the Wall Street sense -- in government bonds or the stock market.

The President’s victory on health care does shine some light in the midst of all this gloom. A healthy person is likely to be a better student and a more productive worker and less likely to end up in jail. The new surtaxes on high incomes and expensive health care plans appear to be far more progressive than the Clinton tax increases. However, the new law will surely accelerate the increase in health care costs as it covers more than another thirty-million previously uninsured Americans without meaningfully reforming or enlarging the existing institutions that deliver health care in America. The same thing has already happened in Massachusetts whose pioneering attempt at universal coverage was the template for the national system. As in Massachusetts the new federal legislation will make it easy for people in need of expensive procedures to obtain inexpensive coverage without effectively requiring every healthy person also to pay for coverage. Economists call this problem “adverse selection” and Paul Krugman identified it as a fatal flaw in Obama’s health care proposals during the Democratic primaries. However, for the time being it could be a much needed if inefficient economic stimulus, except that most of it won’t start to happen for another two or three years.

The federal government, which should be the borrower and spender of last resort in our present situation, has dug itself into a hole similar to the states over the forty years since the tax revolt began in earnest. Tax revenues as a percent of national income have fallen steadily, except for a brief reversal under President Clinton. Spending has increased, driven primarily by Social Security, healthcare programs and the costs of expanding an active, global military presence. Everything else has been squeezed and Obama’s budget now proposes freezing these

expenditures through 2013. That is to say everything that we think of as government activity – education, housing, roads, Amtrak, environmental protection, housing, harbors, airline safety, courts, tax collection, regulation of businesses and much more – will effectively be forced to contract at whatever turns out to be the rate of inflation. But, incredibly, all of these expenditures combined are now only 446 billion dollars, or about eleven percent of government expenditures. The federal deficit is more than three times bigger than these expenditures, so even eliminating them, let alone freezing them, will not get rid of the deficit.

Meanwhile, total military spending, as under-measured in the official budget, will increase by 105 billion dollars or sixteen percent over the same three years that civilian spending is frozen. Only military expenditures are immune from budget cuts, a presidential decision with wide, bi-partisan support. The Pentagon's record on the battlefield may be spotty, but it is undefeated in the U.S. Congress.

A prompt withdrawal from the ill-conceived invasion of Afghanistan would be the morally, legally and strategically correct thing to do. However, it appears that the more likely trajectory is a prolonged escalation and increase in troop levels in the interest of “winning” an unwinnable war, or losing it in a way that punishes the “victors” sufficiently to deter the next engagement. For example, the Taliban might agree to join a ruling coalition in Afghanistan with more tolerance for the less fundamentalist tribes of the north, although certainly not for the rights of women, and to refrain from hosting Al Qaeda in the future. Although all the evidence of the present and of history suggests this is a pipe dream, most of the American establishment, including the White House and the Congress, cling to the idea that this war will end more successfully than Vietnam.

Indeed they cling as well to the illusion of the moment that we have already won some kind of victory in Iraq, where in fact the United States has single-handedly destroyed the rights of women by replacing a secular dictatorship with an Islamic fundamentalist regime, also turning Iran's greatest enemy into its closest ally. The end of the war in Vietnam was followed by the killing fields in a destabilized Cambodia as well as the collapse of the dollar and the Bretton Woods world monetary system and the emergence of virulent inflation. The born-again illusion of American omnipotence may lead yet again to unexpected fateful reversals: perhaps another collapse of the dollar; perhaps the overthrow of the government in nuclear-armed Pakistan, or war between Pakistan and India.

As is typically the case all of this gloom for Main Street does not translate into the equivalent for Wall Street. Stocks started to rally far ahead of anything else, as usual, and have now advanced by 75% from their lows thirteen months ago. Part of this advance has been a relief that a catastrophic collapse has been avoided. And another part has been fueled by the factors that cause many stock market advances: low interest rates, low inflation, slow growth (we expect less than 2% a year for the next five or ten years as was true in the last ten years), high unemployment, low wage growth and high increases in output per worker which lead to increases in profits out of all proportion to increases in national output or income.

In our view stocks are now fairly priced. From this point forward they are likely to provide investors with greater returns than bonds or cash but probably well under ten percent a year. This is equally true of stocks in the U.S. and in emerging markets where the superior growth prospects of countries like China, India, Indonesia and Brazil have been fully reflected.

While European stock markets have been weak over the past four months they still may not incorporate the unpleasant consequences of the crisis in countries using the Euro as their currency. Despite the enormous growth of government deficits and the prospect of more to come, because of slow growth interest rates on government bonds are likely to maintain the relatively stable levels they have held since the crisis began in 2007.

At the same time we are well aware of the great uncertainties surrounding us now. Governments, businesses, homeowners and taxpayers have all made a sort of Faustian bargain with the Devil in recent decades. He has presented us with his bill and everyone is trying to beat the Devil at his own game by having governments borrow still more money and lend it to leveraged speculators to inflate the prices of damaged assets. So far this game is working once again with the help of new Wizard-of-Oz accounting rules; but the potential for renewed financial distress is still strong along with the various possibilities for military, political or terrorist reversals.

Given these expectations, we are generally around ninety percent of fully invested in common stocks, with the emphasis on the United States, Japan and emerging markets. Our investments are unusually diverse, spread over almost every sector. The largest amounts are in information technology and materials stocks, as well as beneficiaries of growing consumption in emerging markets. Much of what is not in stocks has been put back into bonds as an insurance policy against a renewed downturn triggered by a crisis in Europe or a too sudden cessation of government stimulus in America or some other unexpected bad news.