
October 16, 2001**INVESTMENT POLICY MEMO**

The horrifying and quite unexpected events of September 11th dramatically changed the outlook for almost everything, including the economy and financial markets. To say this is commonplace but also true. Equally true but far less commonplace is the observation that the events of September 11 accelerated a number of trends that were already well underway. A mild recession that was almost over became deeper and longer. The Bush administration's two-pronged attack on the surplus (lower taxes and higher spending) gained speed. In its first eight months the administration had approximately eliminated the surplus built over the previous eight years. In the last month they have begun to construct a renewed and durable deficit. Of course all of this has only been possible with the willing cooperation of both parties in Congress.

As of today even the new war against terrorism turns out to look a lot like the old bombing campaigns against everyplace from Dresden to Tokyo, Cambodia to Serbia, Laos to Libya and Iraq. Never mind how familiar the Joint Chiefs and the Commander in Chief might be with the usual failure of these tactics to achieve their objectives in the past. Firing missiles from afar and dropping bombs from on high has the distinct political advantages of minimizing or eliminating American casualties and keeping the deaths of Afghans invisible to TV viewers and air force pilots alike.

Many aspects of our situation are new and sometimes unique at least in U.S. history. This is the first time we have ever embarked on a war – which could prove long and costly – with a splurge of tax cutting. The reality and the fear of terrorism in our own country are likely to continue to profoundly affect social and economic activity. Transportation will become slower, more expensive and less frequent. The long decline in the stock of inventories relative to sales will be reversed. Our economy will be hobbled by its defenses against terrorism in the same way that economies from Mexico to South Africa have been impeded by ubiquitous crime.

An astonishing breadth of economic initiatives has been proposed since the attacks: accelerating tax cuts for the rich (capital gains, estate taxes, lower rates on income); new tax cuts for corporations (lower corporate income tax rate, bigger depreciation allowances, another investment tax credit); more money for the poor (rebate checks to those who didn't get them because they don't pay taxes, extended unemployment benefits); more spending for the military of course and for repair and rebuilding of the target sites ; also more spending for security and airline safety, for bailing out the airlines and subsidizing the insurance companies; more spending on public health and public water supply; more spending for railroads and highways; more spending for education; and no doubt several more that have escaped my attention. Each of these ideas has been endorsed by at least one member of the administration or a leading Republican in Congress.

The proposals to provide new cash for the poor by various means would clearly help to offset the economic contraction we are now experiencing. Proposals to cut taxes for the rich or for corporations will provide much less short-term stimulus to the economy whatever their long-

term effects might be. Similarly the various proposals to increase spending on different kinds of infrastructure will directly stimulate the economy and in most cases fill an actual need. In contrast, tax policies designed to stimulate general investment will surely produce less effect, especially in an economy that has recently experienced a euphoric investment boom. As for subsidies to the airlines and proposed contingency funds to the insurance companies, the immediate effects again are to sustain economic activity. The distressing aspect is that \$15 billion was provided to the airlines in the twinkling of an eye with no return demanded for taxpayers.

How much of this cornucopia of economic stimulus is likely to be delivered? Most of it. The military spending part is a done deal. As I write this, the U.S. is probably spending extra money on cruise missiles, bombs, fuel and personnel at the rate of \$100 million dollars every few hours. Only Congresswoman Barbara Lee of California voted against the first \$40 billion dollar appropriation to fight a war against unnamed terrorists in unnamed countries selected in the sole and secret discretion of the president. (How easy it was for Congress to forget the regrets it expressed over the Gulf of Tonkin Resolution and the secret wars revealed by its Iran/Contra investigations.)

More spending for security is also a done deal. We will have more and better paid security staff in airports, sky marshals on airplanes, more public and privately employed security personnel everywhere, not to mention more security and surveillance equipment. All told this could amount to a couple of hundred thousand new jobs. For comparison this is exactly the net number of jobs lost in September.

Before September 11, the Republicans achieved only half of what they aimed for in tax cuts for the rich. Now, in an atmosphere of patriotic exuberance they are bound to achieve more. The president in part to pave the way for tax cuts for the wealthy, in part to sustain his bipartisan "consensus", and in part because the administration knows that this will be the most effective and timely antidote to recession, is generously proffering more money for the poor. As a consequence, this is likely to be one of those rare moments in our history when the poor actually get something.

The greatest uncertainty surrounds the various proposals for infrastructure spending. The air traffic control system was already in desperate need of overhaul. Now a new impetus has been provided to fund that effort. The system for funding highway improvements is so complex and so fixed in time that it is unlikely to be significantly changed as a result of the terrorist threat or our response. Railroads also are likely to continue suffering a shortfall of public support. America's energy supply system was also seriously out of whack before the attacks. Now interest in fixing it is likely to be enhanced by the national security arguments but also diminished by the fall off in energy demand caused by the recession. Our educational infrastructure is also inadequate and in disrepair. The president has been interested in increased federal spending on education which he is likely to get now more easily than before. On the other hand, the recession may reduce the willingness of local taxpayers to increase their expenditures for education.

Altogether, the measures passed before and since September 11th and those still likely to become law will produce additional economic stimulus over the next year between \$150 and \$200 billion. As Senator Everett Dirksen said nearly fifty years ago, “A billion here, a billion there, pretty soon you’re talking real money.” Or are we? The size of the U.S. economy is now \$10 trillion versus about \$500 billion at the time Dirksen spoke. Or to quote another American who knew what he was talking about, J. Paul Getty, “A billion dollars won’t buy what it used to.” This is certainly true in the case of economic stimulus. How much is the economic drag that needs to be overcome by this stimulus? So far the economy has declined by less than \$150 billion. Even on a gloomy forecast that will still be the case at the end of the year. So at first glance the amount of stimulus proposed may be adequate to end the recession. However, bankruptcies, cutbacks and layoffs have been unfolding at a precipitous pace since September 11th. The shock and fear of the original attacks might have diminished over time; but the reality of various anthrax exposures, the calmly worded threats from Osama bin Laden and the effects of economic reversals and the fear of more – all of these elements might combine to continue pushing down the economy and the spirits of people.

In other words there are numerous and quite different courses the world might follow in the next few months and years. None can be ruled out with confidence or dismissed as highly unlikely. We might experience a disastrous worldwide depression with or without the impetus of further military or terrorist tragedies. We might remain stuck in a prolonged period of listless economic activity with little or no growth. We might experience a reasonably normal recovery of the economy and of people’s animal spirits based on some perceived progress in reducing the risks of terrorism and war, renewed investments in needed areas of infrastructure and the return of confidence among businesses and consumers.

If we avoid the disaster outcomes (human and economic) then we have probably seen the end of declines in inflation and interest rates that have persisted over the last twenty years. The switches from surplus to deficit, from e-commerce to war, from computer programmers to security guards, from streams of illegal immigrants to closed borders, all these changes suggest higher inflation, higher wages and higher interest rates. With or without any additional disasters we are now in a world where stock prices will be lower than they were for the past fifteen years relative to earnings, dividends or assets. Higher stock prices since the end of the Cold War were driven by lower inflation and interest rates, high growth of the economy and profits, unchallenged American hegemony, and the perception that the world’s uncertainties had been reduced. Each of these positive elements has now been reversed or thrown into great doubt. In the future stocks are likely to sell at lower multiples of more slowly growing earnings.

Under these circumstances my current targets, where tax considerations permit, are to hold about one-third of a portfolio in cash and other quite safe high-yield or stable price investments; more than a third in stocks that would do well in an economic recovery and a little less than a third in stocks (healthcare, food, groceries) that would hold up well in a depression or prolonged recession. I aim to keep between 5% and 10% of portfolios invested in each of Europe, Latin America and Asia.