

July 9, 2003

INVESTMENT POLICY MEMO

Whatever true things our last Investment Policy Memo may have said about the world, the war and the country, it was completely wrong about the stock market. On April 14th the market had risen more than 10% in the previous month. I was skeptical in word and in actual investment policy that it could go much higher. The next two months saw an additional rise over 10% most of which is still in place.

In my concern over the potential for the Bush administration's new imperialism to yield a myriad of undesirable consequences I may have lost sight of a simple stock market truth: While equity investors certainly look ahead, they generally don't peer much farther into the foggy future than the next twelve months. Neither Iraq nor Afghanistan nor any new American target is likely to be transformed into another Vietnam in the next year. The diminution of the global institutions and alliances that were designed to preserve and expand capitalism is likely eventually to mean dire consequences for capitalism; but again most probably not in the next year or even on George W.'s watch.

This having been said, and at the risk of once again looking instantly foolish, I will say that the stock market at current levels fully reflects the best news for stocks that we are likely to see over the next year and beyond. Therefore, the chances that it will stay where it is or go down are far greater than the chance of rising another 10% this year.

Consistent with this belief we continue to hold sizable cash reserves. The equities that we favor are, with the exception of some health care companies, not among those that have done well in the last four months, nor those that will do best if indeed we actually have a pick up in economic growth with continued low inflation as the consensus continues hopefully to forecast. Rather they are stocks that are likely to hold up well in a market decline – energy companies, stocks with high dividend yields and low valuations. Many of them will also do well in an energy crisis or a renewal of general inflation. I continue to think that reducing the risk of losses is more important than usual.

In Afghanistan and Iraq the “post-victory” environments remain chaotic. Bandits and warlords are ubiquitous; Islamic fundamentalists resurgent. Plans for indigenous, never mind democratic, governance are on indefinite hold. American forces are not viewed as heroic liberators. Public health, police and other services and public facilities of all kinds are in shambles and not being rebuilt. (The plan is to rebuild them in Iraq at the Iraqi's expense by selling Iraqi oil; but oil production is still less than domestic consumption.) In both countries American and British troops are under daily attack and engage in daily counterattacks.

Perhaps things will just simmer this way for a while without escalating. Perhaps the fighting will diminish. Almost certainly new tyrannies and horrors will visit each country after America finally leaves. Why should the stock market care if Baghdad is, in Donald Rumsfeld's

mischaracterization, as dangerous as a big city in the U.S.? (Actually, it appears that deaths by gunshot and other violence are as frequent among the 50,000 or so U.S. troops in Baghdad as among the 7 million people who live in New York. Maybe Rumsfeld just didn't count Iraqi deaths.) After all, what does any of this have to do with the price of Microsoft or General Motors?

Not only is the stock market indifferent. The rest of America is also mostly indifferent. Plutus, the god of wealth, is blind, and most particularly to moral transgressions. America's moral sensibility has been blinded by the numerous corrosive effects of wealth. The presidential hopefuls in the Democratic Party think criticism will ruin their already remote prospects to overcome the president's popularity and campaign funds. It is seemingly too much to expect that one of them would point out that the president has not and is not building a new example of democracy and freedom in Iraq or Afghanistan. By the time one of them gets the nomination and is confronted with the exigencies of an uphill election battle, he might be willing to castigate a dishonest and immoral occupation, especially if the fruits of America's victories continue to emit such rotten odors. But, with the White House unilateralists still riding high, at least in Congress and the media, the probability increases that yet another war in the Bush jihad will be launched in fact or in rhetoric in time to help the president and his party in next year's elections.

Meanwhile economic recovery in the U.S. and in the entire world continues to be anemic. Unemployment is rising in America, Germany and Japan. Stupendously high levels of unemployment in the developing world also continue to worsen. The recession that began and more or less ended in 2001 was the mildest recession in American history. Given that it was preceded by the longest boom and a huge speculative bubble, it can be argued that we "needed" a bigger recession to "cure" the excesses of boom and bubble. Central bankers always and everywhere have taken this position with the remarkable exception of Alan Greenspan.

For years Greenspan did his best to avoid ending the boom or bursting the bubble. When each ended anyway, the Fed provided the greatest surge of monetary stimulus ever. At nearly the same time the Bush Administration's spending increases and tax cuts contributed the greatest fiscal policy stimulus ever, although not well designed to induce the biggest possible economic response. Yet the economy is still in the doldrums. This is more than a little embarrassing for those of us who were raised as Keynesians and who sharpened our political teeth on the self-righteous mendacity of central bankers. Federal Reserve and Federal Government are doing just what we always said they should do; but the economy is certainly not doing what we said it would do in response.

Why not? There are a handful of middle size answers. The recession plus changes in federal tax policy to which state taxes are geared have created a fiscal crisis in state and local governments to which the response is spending cuts and rising taxes. These neutralize about 10% to 20% of the federal fiscal stimulus. And of course the tax cut side of the stimulus is heavily aimed at the highest wealth and income brackets which are least likely to spend new tax cuts. Tax cuts and low interest rates are inducements to people and businesses to spend more, but they do not compel more spending where it is not needed or desired. Households have responded to low interest rates by buying autos and houses at the high levels that existed during the boom. But simple demographics are against any substantial increase in these areas.

Business investment has not recovered because many areas are still in a post-bubble glut of capacity, notably telecommunications and information technology. Generating capacity for electricity also was raised to excessive levels by the vagaries and manipulations of the market. Investment is subdued in most other areas because capacity is at least adequate and growth is slow. The areas with the greatest investment needs are in the public sector: road, rail, air and public transportation; clean air; clean water; new schools. Here the Bush administration has been openly hostile to spending federal money or subsidizing state level investments.

A possibly bigger part of the problem is the change in the system's ground rules and the loss of confidence that has been engendered by massive revelations of corporate scandal and abrupt changes in U.S. foreign and domestic policies. Perhaps it was too facile to say that these impediments would disappear once America had "won" the war against Iraq.

Bigger still may be the fact that we have as yet unwound only about half of the distortion of savings that happened during the bubble. Businesses and households did not distinguish rising wealth due to rising stock prices from rising wealth due to the accretion of savings. Saving for the private sector plunged from plus two or three percent of income to minus the same amount. After the bubble, spending slowed down and savings increased so that the private sector is now at about break even -- i.e. spending all of its income but not more than all of it. No doubt savings would have recovered to its previous positive level had it not been for the rapid increase in house prices and the flow of money from mortgage refinancings made possible by higher prices and lower interest rates.

Greenspan has made clear that the course of housing prices and construction has been a satisfaction to the Fed and, in his view also, a strong prop to the economy. The problem is that the Fed may have replaced the burst stock market bubble by creating a housing bubble. And at the moment at least, by partially recreating a stock market bubble as well. Housing prices are very high relative to income and other types of wealth. The amount of money that is borrowed to buy or to carry existing housing has been rapidly rising. The character of the residential real estate market has become notably careless.

Whether or not there is a housing bubble; whether or not we will have general price deflation as seems already to be the case in Germany and Japan, whether investment will eventually respond to the stimuli already provided; whether the dollar will collapse more violently as world investors lose confidence in the U.S., whether the economy will soon grow fast enough to absorb more than all the workers provided by population growth, these are all questions to which I do not know the answers. And neither do George W. Bush nor Alan Greenspan. There is considerably more than a trivial chance that the answer to each of these questions is the gloomy answer. That is why we continue to invest every portfolio with caution and for preservation of existing principal.