
January 3, 2008**INVESTMENT POLICY MEMO**

In the mid 1930's with the Depression still causing widespread unemployment, idle factories and poverty, John Maynard Keynes wrote his famous treatise arguing that we had it in our power -- any sovereign government had the power -- to end the Depression promptly and to end or avoid any future depressions. The means was simply to have the government spend enough money to temporarily replace the demand for things and workers that would normally come from other businesses and consumers once prosperity was re-created. (Cutting taxes was a logical alternative that Keynes did not strongly advocate or reject although most "Keynesians" since have argued that, dollar for dollar, spending is more effective than tax cuts.) Keynes argued bitterly against the advocates of free (from government interference) markets, who believed that in the long run they would restore full employment. He observed that "in the long run we are all dead."

In the mid 1960's, the eminent economist Milton Friedman and his equally brilliant and ideologically rigid co-author Anna Schwartz wrote their majestic Monetary History of the United States, a significant portion of which was devoted to the ten years of the Depression. Coming at the subject from a pole completely opposite from Keynes, they also concluded that the Depression and all depressions could have been avoided and could be avoided in the future by appropriate government actions. However, in their version of this principle, the government body that takes appropriate action is the Federal Reserve or whatever other countries call their central banks. And the appropriate action is to supply more money rather than cut taxes or increase spending.

For Friedman and Schwartz a central bank that supplied money to the economy according to a fixed rule and otherwise took action only under exceptional circumstances, was the appropriate way to insure a framework in which the free market could maintain or quickly re-establish full employment. (In fact they preferred the system that prevailed before there was a central bank in which the interest of privately owned banks in surviving eventually led them to take effective, collective actions in response to crises.)

For a long time after the Friedman and Schwartz history was published advocates of higher spending or lower taxes as the cure for depressions were in vehement dispute with those who favored monetary policy, even though they shared the important common ground that governments always had it in their power to terminate or prevent depressions. Over time the two sides have drawn closer to each other. The press is now full of letters from scholars at the American Enterprise Institute or the Hoover Institution (Milton Friedman's last redoubt) reminding us of New Deal programs that effectively purchased defaulted mortgages from banks and arranged refinancings for the homeowners, along with letters from Democratic members of Congress and like minded academics urging dramatic cuts in interest rates and increases in money supply as well as fiscal stimulus.

Actually George Bush stole the mantle of fiscal stimulus from the Democrats when he began his presidency with the largest and most aptly timed dose of stimulating tax cuts and spending increases in all of American history: taking the modest but very rare surplus at the end of Clinton's administration and turning it overnight into a record smashing deficit. As a result many Democrats are now advocating steps back toward a balanced budget, although this would necessarily mean less fiscal stimulus to an economy that is already at the edge of recession.

So we are at a significant crossroads. Which will be proven correct: the forty-year consensus among academics and policy makers, that governments can always do something to trump disaster, or the more widely popular consensus, at least in America, that whatever their powers governments never manage to get it right? For a large part of 2007, the utterances and actions of politicians and central bankers seemed on balance to support the pessimists. Central bankers, especially in the UK and the USA were busy muttering about the risks of inflation, the risks of bailing out businesses or individuals who had made extremely risky or imprudent investments and their perception that whatever damage was done by the nearly global sub-prime mortgage loan implosion and the consequent credit crisis among banks, was likely not to affect the economy as a whole. Many of these statements can be found word for word in the pronouncements of central bankers from 1929 until 1933 (extensively quoted and condemned by Friedman and Schwartz), which makes them a very frightening portent.

From August through September another echo of the Depression of the 1930's was provided by the persistent and large differences among the leading central banks. Initially the Bank of England was extremely reluctant to take any unusual action at all and the U.S. Federal Reserve was quite close to the same stance while the European Central Bank began to provide extraordinary amounts of money to banks in the Euro area almost immediately. The reason for this divergence may have been superior analysis or intuition on the part of the ECB, or it may have been the surprising emergence of multiple banking crises inside the European Monetary Union when there were still no visible problems elsewhere.

Before long the United Kingdom experienced the first major run on a bank in any developed country in more than seventy years. Indeed it has generally and alarmingly been the case that, while the issue of risky mortgages and resale of those mortgages packaged as securities or to intermediaries who in turn issued securities was all pretty much an American affair, the problems caused by their decline have affected banks from Poland to England, France to Greece and Hong Kong to Tokyo. The crisis has therefore been beyond the borders of the U.S. from the beginning. And it has also raised threats beyond the borders of banking and home mortgages. Falling house prices and foreclosures have led to rising default rates for better quality mortgages as well as on credit card debt and student loans. The American economy has ground to a halt or gone into reverse because the effects of the housing and banking mess have had an impact on business investment and consumer spending.

Is it time to run for the hills? We think not. Since October the world's central bankers have been changing their minds in the face of the failure of their policies to achieve stated goals. In early December they made a very important and historically unprecedented joint effort to combat the financial crisis with a coordinated effort. It is worth emphasizing that this harmony among central bank policies has never been achieved before in a time of similar emergency:

certainly not in the early 1930's; nor in the tug of war between the Fed and Germany's central bank that ended with the stock market crash of 1987; nor in the global financial crises of 1997 and 1998. Not only that, but what the central banks agreed to do and have been doing, actually makes good sense.

First the Fed and others have agreed to hold regular "auctions" at which a fixed amount of money is on offer to banks who can post a much wider than usual range of assets as collateral. This is a technique that had already been in use for some time by the Bank of England. It has the advantage of removing any stigma (because it removes visibility) for the banks that borrow. It also offers longer-term money, which has been particularly difficult and expensive for banks to obtain, and it will be offered, according to the central banks, as long as it is needed and as much as is needed. For the first time in six months this has had a pronounced impact on many interest rate costs to the banks although it has not eliminated all of the anomalies that appeared when the crisis began. The most important aspects of the central banks' coordinated effort over the past three weeks are that they are coordinated at all, that they embody a good understanding of the problems and a firm, open-ended commitment to do what is necessary. The role of conflicting politics, ideologies, prejudices and personalities in the series of missteps that brought on the Great Depression was undeniably very great.

In addition to the central banks, the federal government and a number of state governments have also taken steps to intervene in mortgage markets to prevent or reduce the impact of defaults and foreclosures. To be sure these efforts so far are rather weak, like the first steps of the Hoover White House to combat the Depression. Nevertheless they are unusually swift and forward looking steps and are generally of the right type if not the appropriate volume.

Beyond these government steps, developments in the private sector have also been unusually encouraging. Just two weeks before the central banks' joint action, the largest bank in the UK took a singular action of great significance. HSBC decided to put \$35 billion of assets it had created and effectively sold to others "back on its balance sheet," which actually meant that it's implicit guarantee was made explicit although the assets are still only a footnoted contingency on its balance sheet. Still, the effect was large and helpful. The SIV Superfund that had been cooked up by the Treasury and three large U.S. banks immediately collapsed. This was a good thing because the entire fund was based on an attempt to use accounting gimmicks to hide the problem or to use money from banks with cleaner balance sheets to partially bail out the banks who had contributed most to the problem. What then followed was the imitation of HSBC's action by almost every major bank in the world.

One effect of these steps was to eliminate uncertainty about how much bad stuff was around, who owned it and who would end up paying if there were additional defaults. Another was to accelerate the reduction in the outstanding supply of commercial paper nobody wanted to own. Yet another less positive effect, which the banks (and the ever helpful Secretary of the Treasury who deserves partial credit for creating this crisis when he was head of Goldman Sachs) had been struggling valiantly to avoid, was an automatic increase in the capital these banks were required to hold to support their larger and riskier pool of assets and contingent liabilities. Here too, commercial banks and investment banks have had a run if not of luck at least of salvation.

So far commercial banks and investment banks have received over \$100 billion of new capital investments since the crisis began in June. Not only the amount but also the speed of these investments is unprecedented. And most unusual of all are the investors themselves, who are virtually 100% agencies of foreign governments: China, Singapore, Malaysia and a host of Persian Gulf oil producers. Bank of America was an early exception to this trend when it invested in mortgage lender Countrywide. However, not long thereafter Bank of America along with about every big bank in America found that it needed capital to compensate for its losses on mortgages and related activities. All the usual previous investors in troubled banks – other banks, Wall Street investment banks and hedge funds – were in too much trouble to bail each other out. Warren Buffett, whose Berkshire Hathaway had enough idle cash to have done half these investments, decided to pass. And so our enemies of yesterday, China, OPEC and various Muslim states, now own significant stakes in almost every large financial institution in America. This has happened, and nobody has objected very loudly (remember when Abu Dubai was about to become the owner of the manager of some large American port facilities?) because, to transpose the famous remark of bank robber Willie Sutton, “that’s where the money is.”

Whatever all this might say about America’s declining world status, it is unquestionably very good news for the economy and financial markets. New capital is by far the most potent medicine that can be administered to ailing banks, and it has been provided widely and generously.

To this compendium of reassuring news we add a fact on which we relied as long ago as August, the United States still, indeed more than ever, has the best Congress and the best President that money can buy. The buyers of these trophies have everything to lose from a collapse of the financial system or a serious depression. In sum, we are squarely on the side of the optimists. This is not to say that the U.S. and most likely Japan and much of Europe will not experience a recession. A recession may already be underway. But, a severe financial crisis and related severe recession or depression, seem extremely unlikely.

Even mild recessions normally result in greater stock market declines than we have seen thus far. Accordingly, we continue to maintain large holdings of cash and bonds even in portfolios that would normally be all in equities. But, after the events of late November and early December, we used some of that cash to increase holdings in developing countries and in financial stocks of which we continue to own very few.

We hope to do as well for our clients in the coming year as we did in the last. For all of our readers we hope for a healthy and happy 2008 as well as a year that brings peace to our troubled earth.