

Mid-2010

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## *FDR's Fiscal Policy Redux*

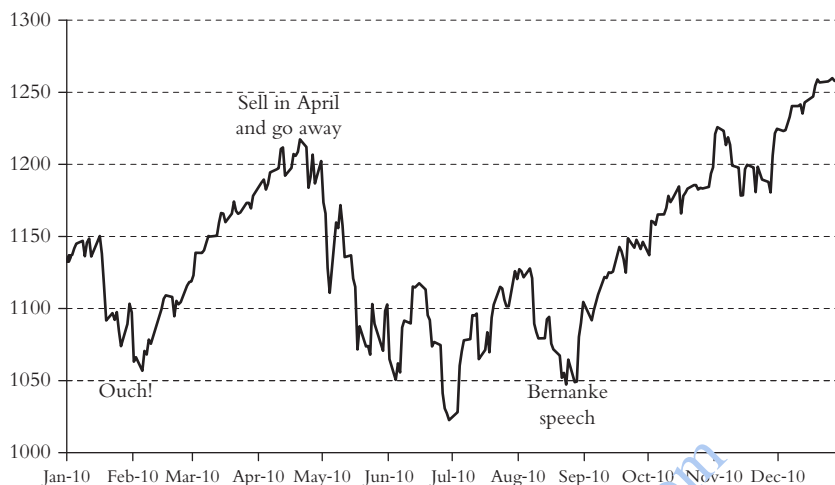
*After a very strong 2009, markets rallied briskly through most of April and a whiff of “maybe we are truly out of the woods” exhilaration swept through the still traumatized crowd, most of whom were still licking their wounds. We gained almost 6% in March, then abruptly a painful correction began at the beginning of May. Once again the chorus of “sell in May and go away” was heard.*

*We begin the diary in the first days of July 2010 with the S&P 500 down and the fund off 6.6% for the year to date. Not a happy time. As you will see, I was too cautious and as a result missed the first somewhat timid leg of the move higher that was developing. As usual, there were compelling arguments from both the bulls and the bears, but as markets fell, for uncertain souls like me the negative case became more compelling. Fortunately, long positions in U.S. energy stocks and in Asia kept me going. The gains of July were mostly retraced in August. The moral of the story is that you were probably better off to keep your powder dry until the fog of war lifted and then load up in late August, early September.*



*July 8, 2010*

**E**quity markets and the high-frequency economic data around the world are weakening. Over the last couple of weeks, employment numbers, production indices, house price measures, and funding market stresses have been uniformly disappointing—and disconcerting. The S&P 500 sets the tone for the world, and in the last few days it has stumbled through the February and June correction bottoms reaching a new low for the year, and Treasury bond yields in both America and Germany are setting new lows. What’s more worrisome is that it is beginning to appear that the so-called Authorities are on the verge of



### Keep Your Powder Dry

*Data source: Bloomberg*

making a serious policy error comparable to what occurred in the 1930s by prematurely tightening fiscal policy.

Until the last week or so the received wisdom was that the global economy after its powerful recovery was entering a “soft patch” for several quarters during which growth would continue but at a slower pace. It was generally conceded that the stimulus programs were beginning to run off and that the recovery was healthy but not yet self-sustaining. In other words, that the patient was still a little fragile. The European sovereign debt crisis and funding issues in the banking system also were creating some uneasiness. Meanwhile, in the U.S., consumer confidence was falling faster than expected and measures of economic growth such as retail activity, the PMIs and ISMs were clearly showing that the pace of growth, the so-called second derivative, almost everywhere was slowing. More ominously the ECRI leading indicator (which, incidentally, has had an excellent forecasting record) has collapsed to a 45-week low in the most precipitous slide in fifty years. Investors were beginning to get nervous although the businessmen we talked with in the U.S., Asia, and Europe were telling us of strong order flows and activity.

On the other hand, at this stage of a recovery cycle after a full-fledged financial panic, doubt and worry about the vibrancy of the economy are normal. The bears come out of the woodwork. Alan Greenspan made

this very point last week in an interview on television. ISI points out that in September 1992 *Time* magazine, at a similar cyclical moment, wrote:

The US economy remains almost comatose. The slump already ranks as the longest period of sustained weakness since the Depression. The economy is staggering under many structural burdens, as opposed to familiar "cyclical" problems. The structural faults represent once-in-a-lifetime dislocations that will take years to work out. Among them: the job drought, the debt hangover, the banking collapse, the real estate depression, the health-care cost explosion, and the runaway federal deficit.

This paragraph sounds like what the doomsayer economists whose last names begin with R. on CNBC are saying today. The great economist Joseph Schumpeter liked to say: "Pessimistic visions about almost anything always strike the public as more erudite than optimistic ones." It turned out that the economy was in a temporary soft spot in the fall of 1992 and stocks were about to soar. In fact, one of the greatest bull markets in history was about to begin.

However, the new development in the current equation is the tightening bias of the Authorities and the extreme rhetoric and power of the austerity brigade. Just this past weekend the chairman of the European Central Bank (ECB), a moderate man, added his voice to the chorus. Although most of the savants are maintaining that additional fiscal juice is needed to prevent the present global "soft patch" from becoming a "double dip," the high priests of the temple who want us to be punished NOW for our sins with immediate pain and suffering are calling for no more stimulus.

As it has turned out, President Obama was the only leader at the G-20 meetings calling for more stimuli to sustain what he labeled as a "still developing recovery." Ironically, the president's own country is not listening. The Congress last week failed to extend unemployment insurance and is considering other measures to restrain spending. With the mid-term elections only months away and visions of Tea Parties dancing in their heads, partisan politics are affecting the willingness of many incumbent politicians to approve new spending programs. As it stands now, the U.S. will withdraw from both structural and cyclical forces about 4.5% of fiscal impetus from real GDP over the next five quarters as spending legislation and tax cuts expire.

At the same time, the other major economic powers are imposing fiscal austerity of one type or another to shrink budget deficits. To wit: the new U.K. government has presented a stringent emergency budget that adds to the tightening already in place another minus 4.3% of GDP; the new Japanese prime minister says he is going to restrain JGB issuance and raise taxes; and European fiscal policy is frantically moving towards the most aggressive tightening in more than four decades. The most extreme examples are Spain's, where fiscal impetus is targeted at minus 5.4%, Portugal minus 6.9%, and Greece minus 6.8%, with Germany, France, and Italy in the minus 2% area. However, bear in mind that the recovery from the recession in Europe (with the possible exception of Germany) is barely perceptible. Emerging Asia where the economic resurgence is by far the most firmly based also is justifiably tightening, and a few Asian central banks are actually hiking interest rates. On the other hand, China, the third largest economy in the world and one of the principal growth engines, seems to be attempting to reduce real GDP growth from its current 10-11% to 7-9% over the next four quarters.

Thus the worrywarts like me are afraid that the U.S. and the world are going to repeat the error that Franklin D. Roosevelt (FDR) made in the late 1930s. FDR, assailed by conservatives for his boondoggles and public spending programs and believing that the Great Depression was over, in early 1937 imposed tax increases and drastic spending cuts that took about 5% out of GDP—or about the same amount as we are doing now. Then industrial production plummeted, the economy aborted into another recession, and the stock market, which had tripled from its 1932 low, plummeted 50% and gave back over half of its gains in 15 months. Back then the German economy was the strongest major in the world and Europe in general was increasing defense spending as World War II loomed, so its fiscal policy was expansionary—not concretionary as it is today. However, back then there were no billion-population dynamos with high growth rates and potential like Indonesia and the BRICs (Brazil, Russia, India, and China) are today.

After a financial panic, severe recession, and a secular bear market such as we have experienced followed by an economic recovery and major stock market rally that retraces about half of the ground lost, it makes a lot of difference what then happens to the economy. At about the stage of the revival that we are in, it is normal for business activity

and the stock market to become choppy as investors and businessmen are still licking their wounds. If after its big revival the economy transitions into nothing more serious than a soft patch of slower growth (say 2% to 3% real GDP for two to three quarters), investors worry but stocks usually pull back only 10% to 15% before surging again. However, if the economy suffers a “double dip” (two to four quarters of real GDP growth of only around 1.5% with no improvement in employment), then stocks can plunge 25% to 30% as everyone becomes really frightened that the stall will turn into another recession. If, heaven forbid, another recession actually occurs, then the declines can be far more severe as happened in the late 1930s. The bears are speaking of a testing of the lows of the spring of 2009.

Complicating the assessment is whether the environment is inherently inflationary or deflationary. For the time being deflation seems to be more of a threat than inflation. As Japan has demonstrated, deflation is a very insidious plague because low or declining nominal GDP emasculates consumer spending (don't buy now because it will cost less later) and corporate profits. If the U.S. and the world slip back into a long stall or another recession, some episodes of deflation are probable. However, Jim Cramer's rants on CNBC about “deflation now” in my opinion are far too dramatic.

So what do I think is going to happen? Frankly, I'm not sure because, as noted, I am very concerned that governments and politicians are making a serious policy error by tightening fiscal policy. A massive dose of austerity makes about as much sense as the 18th- and 19th-century practice of bloodletting from deathly ill patients. Eventually we must reduce the size of government deficits and overall debt, but we need a self-sustaining expansion of the U.S. and global economy to be firmly ensconced before we start raising taxes and drastically reducing government expenditures. By moving prematurely, the Authorities are playing with fire and the outcome could be disastrous. Since I am an optimist (most of the time), I think we will come to our senses on policy. The global economy is frail but regaining its health, although the mature developed countries could be in for a “new normal” of slower, trend-line growth. However the emerging markets are a new and very positive force for world growth and for multinational companies. The BRICs are gradually transitioning from being export-dependent, commodity producers to domestic, consumer

**Quarterly GDP growth forecasts**

	2009				2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
U.S.	-6.4	-0.7	2.2	5.6	2.7	3.5	2.0	1.5	1.5	2.0	2.0	2.0
MEU	-9.5	-0.5	1.6	0.7	0.8	2.5	1.5	1.0	1.0	1.0	1.5	1.5
UK	-10.0	-2.7	-1.1	1.8	1.2	2.5	2.5	2.0	1.5	1.5	1.5	1.5
Japan	-15.8	6.9	0.4	4.6	5.0	3.0	1.5	0.5	0.5	1.0	1.5	1.5
China	7.2	14.1	10.8	10.8	13.1	8.0	9.5	7.0	7.0	8.5	8.5	8.5
Rest of Emerging Markets	-10.5	5.7	8.0	8.1	4.5	8.3	5.5	4.4	0.4	4.5	5.0	5.0
Rest of Developed	-7.0	2.2	1.9	6.3	5.7	3.3	2.5	2.0	2.0	2.5	2.5	2.5
Developed	-9.2	0.4	1.5	3.2	2.3	3.0	1.8	1.2	1.2	1.5	1.7	1.7
WORLD	-7.9	2.9	3.8	5.2	3.9	4.6	2.2	2.4	2.3	2.7	3.1	3.1

Source: Traxis Partners LP

demand-driven growth. That's good. The only consistently profitable extractive industry is dentistry.

The table on page 8 summarizes our most likely outlook. As you can see, it envisions a mild double dip.

For the time being, I am reducing my exposure to equities very substantially. I think a long-only equity account should have its maximum permissible cash position. What would make me change my mind? Several months of rising employment numbers, a firming of house prices in the U.S., real progress on stress testing of European banks and the unlocking of the banking system, or another significant injection of fiscal or monetary (quantitative easing by the Fed) stimulus in the U.S. Obviously a further decline in stock prices and signs of panic selling would also be helpful. At this point my sense is that the aggressive money is beginning to understand the negatives I have outlined above but is not yet positioned for it.

Unfortunately bonds are not an attractive alternative at this point unless you believe a recession with whiffs of deflation is likely. Bonds are already priced for a double dip. Treasuries and bonds are overbought and most other fixed-income markets such as high yield and emerging market debt are extended. High-grade corporate bonds are the least unattractive category.

As for stocks, large capitalization, high-quality American equities with global franchises and good dividend yields are a fine place to be for the long run. In particular, big capitalization technology, capital equipment, oil service, pharmaceuticals, consumer cyclicals, and probably the REITs are attractive. Most major names in these categories are demonstrably cheap on earnings, free cash flow, true book value, and yield. Our studies indicate that only twice in the last hundred years have they been as cheap relative to the rest of the market. There is no urgency to buy them now, but unless you are running a hedge fund I would not disturb long-term positions. If the economy stumbles they will get cheaper.

As the forecast table suggests, emerging markets are still the place to be, but bear in mind that the great global multinationals are major participants in the developing economies. Warren Buffett has said he prefers to get his emerging market exposure through companies like Coca-Cola, McDonalds, etc. I prefer mine through more direct participation.

Chinese equities have had a big and, in my view, an unjustified correction. After a recent visit kicking the dusty tires, I am quite confident China is artfully managing its exchange rate, the economy, and asset prices for sustained progress. My affection also extends to many other Asian emerging markets and the BRICs, particularly India. The longer term, trend-line growth for Europe and Japan may only be 1.5%, for the U.S. 2.5%, but 5% for the developing world. That's a big difference!

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