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Death of Dynamism?

After falling 5.5% from its recent peak in mid-October the S&P 500 roared back this week with a near 3% rally. A steady flow of good news soothed recent worries that the recovery was growing anemic. Ford led the good news parade waving a banner quarter of almost a billion dollars in profits. Tool-maker Stanley Works agreed to buy Black & Decker for \$4.5 billion and the next day Warren Buffett announced that he was in the railroad business with a \$26 billion “all-in” bet on the US economy purchase of Burlington Northern. What was bad news for Mr. Obama and Democrats was good news for investors as Tuesday’s Republican victories suggested the possibility of future gridlock and perhaps some near-term restraint in big government growth and spending.

Stock investors were encouraged on Wednesday by the Federal Reserve’s repeated intention to keep interest rates near zero for “an extended period” while saying for the first time that policy will stay unchanged as long as inflation expectations are stable and unemployment fails to decline. The Fed is clearly of the opinion that the recovery is totally dependent on stimulus. Mr. Bernanke, a student of the Great Depression knows that the second recession was the direct result of the government withdrawing its stimulus too fast.

The dollar sank 1.2% on the news, the biggest intraday decline since Sept. 8th according to Bloomberg. In contrast, as has been the case since March the stock market rallied as much as 1.5% on the news. The dollar will remain under pressure until the Fed begins to withdraw stimulus, Washington backs away from its massive spending plans, or until there is a global shock significant enough for a flight to quality.

With unemployment persistently high and the economy on Federal assistance, the threat of inflation is very low and will likely remain low for months to come. The Fed likely continues to be worried about the possibility of deflation. The difference in yield between 10-year inflation-protected Treasury notes and nominal Treasury notes is 212 basis points, which indicates that bond investors see consumer prices rising by 2.12% per year for foreseeable future. Gold, a traditional inflation hedge is rising to new highs, but more on huge sovereign purchases by countries like India from the International Monetary Fund. Gold is trading near its non-inflation adjusted high of \$1,097.68.

Good news earlier in the week of slowing job losses was overshadowed by today’s surprisingly high headline number of unemployment at 10.2%, which is a 26-year high. Payrolls fell by 190,000 workers last month, compared with a 175,000 drop anticipated by the median forecast of economists surveyed by Bloomberg News. Last month unemployment was at 9.8%.

In response to the news the White House announced that President Obama would sign the Worker, Homeownership, and Business Assistance Act of 2009, legislation aimed at spurring job creation by providing an additional tax cut for businesses, extending unemployment benefits up

to 20 additional weeks, and stabilizing the housing market with a one-time extension of the \$8,000 home buyer tax credit. Unfortunately the “business assistance” is little more than window dressing as it only allows a business to write off losses from 2008 and 2009 against future income.

Earlier in the week the President, while speaking to a panel of business, labor leaders and economists said the US economy has pulled “back from the brink” but the government must now “get serious” about reducing debt and helping spur job growth. He said “the government is going to have to get serious about reducing our debt levels.” It represents the second time the full board has met to brief the president on ways to create jobs and encourage economic growth. Their agenda was focused on “creating jobs through innovation.” They had better ‘innovate’ better and faster.

Prize-winning economist Edmund Phelps says the economy is recovering, but likely will “run out of gas” as it heads into the “new normal.” He argues “there are signs that the economy has lost its dynamism, its urge to innovate, or its ability to innovate.” He also says that it made perfect sense for the government to throw in some fiscal stimulus,” in the recent past. “But now we are in an equilibrium. We don’t like it, it’s a bad equilibrium, but now it’s no longer appropriate to think there is an imbalance between supply and demand.”

Phelps sees unemployment settling into a range of 6% to 7.5% as compared to the 4.9% normal of the ten years ended 2007. “As output goes up, employment is going to continue to lag,” said Phelps. “Firms have gotten rid of a lot of their workforce cushion, so to speak, and they’re going to do without that for a quite a while.” As companies have reduced their ‘cushion’ their existing workers are producing heroically. Productivity, which measures employee output per hour, jumped 9.5% in the third quarter, exceeding all economists’ forecasts. While it is too early to tell if Phelps will be on target with his employment estimates, it is clear that business investment spending and employment will be pushed higher in the coming months the productivity news.

The productivity report also argues strongly for improved business profits which are being born out in the current earnings cycle. With 84% of companies in the S&P 500 reporting, 83% have beaten analysts’ earnings estimates. Earnings estimates compiled by Bloomberg show that companies in the S&P 500 will report combined profit in 2011 that is 54% higher than this year, the steepest growth in two decades. The projected increase for next year is 10 times faster than the gain in GDP foreseen by economists surveyed last month, near the highest ratio on record, based on data compiled by Bloomberg going back 60 years.

So who’s right, the President, the market and analysts; or economists, bond buyers, and currency traders? Perhaps they all are, but over different times and for different reasons. The economy is inarguably in recovery for the moment, but whether it can hold is clearly debatable. Mr. Phelps argues that stimulus will be useless at this point. We believe that targeted tax and investment incentives to small business are vital get innovation going again, but we do not see it coming soon. Washington gridlock may come in the next year or two, but there are no real signs that near-term spending is going to be reduced. Long-term government spending is clearly

out of control with our without healthcare “reform.” Entitlements already on the books will swamp future generations if dramatic and (politically improbable regardless of party) changes are not made soon.

Our country has been on a path toward socialism since FDR. We have steadily abandoned the ideals of our Republic form of government which were carefully designed and embraced by our forefathers. Once one party successfully won by doing for one class by taking from another, the slide began. Voters have steadily demanded more “what’s in it for me” democracy. Leaders, compensated by re-election must steadily kick back legislation for their benefactors whether good for the country’s long-term viability or not.

Unless we take back our heritage from the incredibly powerful, self-serving, and myopic special interests that run this country, we are destined to repeat every economic mistake made by our cousins across the Atlantic. Mr. Phelps, you are right: If we allow our dynamism and our innovation to be devoured by that evil corporation known as Washington, Inc. we will be hopelessly lost in the ‘new normal.’

Virginia and New Jersey were shots across the bow for Mr. Obama and Democrats, in an immediate and micro sense. But every elected official in Washington should take serious notice, including Republicans who now celebrate. This recession has opened the eyes of many voters to a serious cancer, not just among a few bankers and mortgagers, but rather in the very structure of our governance. Republicans were swept to victory in 1994 with the Contract with America and Democrats in like fashion took over in 2008 on the promise of “change.” Both resulted in arrogance and extreme division, stymieing innovation and collaboration.

There seems a greater chance for political balance in Washington in the near term which is a hopeful sign for the economy, but long-term we must find a way to delink the grasp Washington, Inc. has on our leaders. If, as a country we are to rein in government spending which will eventually crowd out private innovation, if we are to seriously tackle the kinds of challenges that face this country such as entitlements and spending, our leaders must be freed from the grip of Washington, Inc. That’s the kind of change we need Mr. President, or future Mr./Ms. President.

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