The rational consumer and other unintended consequences

Massive policy decisions made in haste to solve real problems can easily overwhelm debate about their overall effect – especially if policy is evoked by the same people who created the problem.

For example, a classic debate among economists is occurring and few see the law of unintended consequences as the true arbitrator of the long-term outcome. What, you may say, does that mean?

The debate, first, is among classical Keynesians who believe Washington's fiscal stimulus – fiscal policy – can pull us from this situation. They believe government spending, regardless of the debt created in the process, is needed. It is expressed as "infrastructure" spending – roads, bridges and the like – much like the New Deal years of Roosevelt. They believe this will provide jobs, mitigate further unemployment growth and improve America's lot, in general, to say nothing of the stock prices of the steel, aluminum, copper and heavy equipment companies. All of this in spite of the fact that we are substantially a service, not a manufacturing, economy. It also includes tax cuts although these are rare.

The other voice in the wilderness is that of the monetarist – monetary policy – which purports that recovery can occur only if sufficient money is in circulation and that the Federal Reserve, via the banking system, can and should keep rates low, ease reserve requirements, allow margin debt, etc – all to promote liquidity. They believe the presence of low-cost funds will induce investing by business, support inventory growth and financing and allow consumers to more readily borrow for mortgages, cars and the like, thus restarting economic growth – never mind consumers have quite enough debt.

To varying degrees the various countries around the world are applying these two fundamental tactics to help maintain growth. In some countries, aggressive monetary policy is judged risky (Germany) and so fiscal policy tends to prevail. In others (the United States), monetary policy is at full throttle and fiscal is about to be tried with a $1 trillion or so stimulus package.

In all cases, however, consumer and business confidence is still the trigger. Back in the '60s, Federal Reserve Chairman W. M. Martin coined the phrase "pushing on a string" to describe the results when monetary policy is being applied but nobody cares or picks up the hint and uses it. Equally, fiscal policy has little import if the folks who build the roads save the paycheck rather than spend it. In short, the availability of money does not necessitate its use, regardless of origin. One may even say that at this point a tax "cut" to a middle-class family is more likely to be saved than spent.

And the law of unintended consequences? Well, to my mind the Fed and Washington, with their two strategies, will continue to pour liquidity into the system much as your neighbor does trying to start his charcoal barbecue with more and more lighter fluid. At first – deflation. When it catches – inflation – just as too much lighter fluid looks for too little oxygen, too much money looks for too few goods.

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The answer, if there is one, is that normally slowdowns or even mild recessions can be dealt with via monetary policy (and are usually caused by tight money policies). Serious slowdowns or the current situation of a full-blown recession, I regrettably admit, require both tools.

My fears are inflation from all that liquidity and long delays with zoning, unions, political operatives and lobbyists trying to put fiscal stimulus to work and, ultimately, massive new debt that only taxes can pay down.

And on that point: If, and only if, we cut taxes will we see increased total tax revenue This apparent contradiction has been well proven and our new President is sending signals that he agrees. Which is the good news – both tools, cut taxes, accept some inflation – but watch your eyebrows . . . .

The obvious question to me, at least, is when does this all kick in and save my 401(k)? That's the hard part. Here are a few thoughts:

1) This whole thing blew into town in 60 days or less – instant news, now equal instant results – worldwide. Most ran to Treasuries for safety.
2) If it was as quick as that, will solid good news create instant good results?
3) Balance sheets of many firms are solid and require little or no borrowing – so it's about staying power and earnings for them – and the rest will fail for their inability to finance operations, much less re-issue maturing debt. What few see is that there is enormous liquidity (cash) out there – mostly in Treasuries, but lenders are stricter than ever before.
4) Investors are very slowly looking for more risk (they say "return" but we all know that means risk) because of the low yield in Treasuries, as witnessed by the government making about $8 billion already selling toxic (TARP) assets and the 25% rally in stocks.
5) Can we assume the declines (housing, employment, etc.) continue at the same pace or do they slow? House costs to income ratios are finally approaching long-term levels.
6) What of 0% interest on Treasuries?

Pulling these together leads me to believe a massive bubble in Treasuries is about to burst – and it will be ugly. Treasuries – year bills, notes and bonds – will be under serious selling pressure when #2 above comes to be even partly true. Of course, you can hold Treasuries with 2% or 1% yields to maturity, but it's hard when other assets offer more. In short, any improvement in the debt markets will cause investors to start buying debt instruments and this, I believe, will have a whip-saw effect on Treasuries. I am not saying that we are out of the recession and the sky is blue again, but I am saying that the safe haven of Treasuries is at risk for the great reason that it's now overpriced and credit activity is picking up for good firms. The economy itself has yet to bottom – just so we are clear. Neither is the bear market over – just so we are clear.

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The 600,000 plus new claims is just this month signaling a recession – and I can see unemployment touching 8%, but I am stuck with the fact that, overall, companies in the United States have not built up excess labor forces over the last 5 years or so. Just look at the productivity growth of that period for proof – fewer workers did more. If that's the case, unemployment might not be as bad as many assume it's going to be.

This is a long way around to observing that in 2008, the financial system nearly failed, remedies were thrown into place – some good, some horrible – and the ensuing credit melt down will now lead to companies failing in 2009 as the credit process restores itself for (only) the healthy. In a macabre moment, I envision 2010-2011 when the surviving companies earn more on higher margins from higher prices brought on by higher inflation – at the expense of their departed competition.

This current stock market reflects all this and expects far more.. These short rallies are just that – up 25% off the bottom already (but needing 70% or so to be back to the levels of late 2007), but a rally in a down market is called a bear trap for a reason. These fast, short rallies are typical in such times – and great for housecleaning – but mean little to long-term investors.

I'm not playing. I don't buy global warming and all the "green" investment silliness being put forth any more than the ethanol concept because nobody talks about the unintended consequences of mandating green cars, etc., etc., etc. Milton Friedman said something to the effect that if you put the Fed in charge of the Sahara Desert, in 5 years there would be a sand shortage, so fundamentally, <u>any</u> claim the government can run <u>any</u> business is worthy of severe skepticism. [The Mustang Ranch in Nevada was taken over for unpaid taxes and run by the government. I'm told it went bust (sorry). If you can't make a profit selling booze and sex, what makes you think you can run a car company, Ms. Pelosi?] For traders, have fun – it's your time. For long-term investors, well, be patient, keep the quality stocks and cash.

Speaking of cars, I believe gas has bottomed, oil nearly so, and balance is returning to the corn/wheat markets. When the lighter fluid catches, the oil, commodity and gold indices should move up even more. Ironically, the best corporate balance sheets out there are in tech stocks and I'm working to find a few software firms worthy of a long-term hold. As long as oil is up for discussion – I want my clients to own it, long term. Turning off your lights, or air conditioning to save oil is fine, but recognize that electricity in the U. S. is produced from coal (50%), nuclear (20%), natural gas (18%) and hydro (7%). Wind and solar are about 2% together – the rest is oil. Our oil comes from 60 countries of which Canada and Mexico are first and third. The Persian Gulf provides less than 20% or about $5 billion/month. Our <u>total</u> import figure is about 56%. The point of all this is that oil is about transportation (70%) and winding that down with wind farms and electric cars will take decades – and the consequences are not fully understood.

So – wither from here? Sooner than most expect, the liquidity, especially the liquidity, low inventory and less-than- depression level unemployment will trigger a recovery.

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These rallies are the false starts – I can't see this fear – lack of confidence – going away much before summer and bad earnings are coming. That said, I've kept some cash. Long term, my list of highest quality stocks (see above) will, I believe, survive and prosper at the expense of many marginal firms whose debt is coming due. The economy has a long, hard road to go to full recovery and I intend to miss the first innings in favor of being a lot more certain about the staying power.

Some sectors will improve before others, and I can see owning those stocks. For example, I believe small, regional banks are more likely to garner savings accounts than the largest super regionals because I think consumers have associated failure (toxic assets, etc.) with the giants. A local bank that markets its prudence should do well. Conversely, companies expecting to profit from the fiscal stimulus may have a long wait.

I also believe consumers will begin to spend sooner than most expect. Remember, the bulk of consumer spending is done by a disproportionate minority of people – and we've all been trained by TV to solve our issues in 30 minutes and then go buy something. It's no joke – it's now in our DNA. Caution is the word.

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January 2009

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