GMO

QUARTERLY LETTER

October 2007

Fed Up

Jeremy Grantham

Of course I'm fed up. We had Risk on the ropes. His followers were panicking. They were calling for the ref to stop the fight: "He has absolutely no idea how badly our boy is hurting … he has no idea!" And what does the ref do? Ends the round early, extends the break, and allows a dangerous injection of adrenaline. Risk then leaps out of his corner, apparently rejuvenated, and wins the next couple of rounds. And here we are, wondering whether Risk has taken enough punishment to make him vulnerable to a knockout blow in a later round. Or has he completely recovered?

What a quarter for anyone interested in the workings of the Fed! First they had been rather ostentatiously bullied by Congressional visitors over one provisional month's weak employment data (surely a workable definition of statistical irrelevance), serving to remind us that politics is an occupational hazard for the Fed. But for the record, some Democrat had better get to Senator Dodd (D) soon and explain a basic truth: leaning on the Fed to stimulate the economy in Year 3 is an <u>incumbent</u> party strategy, definitely to be avoided by the challengers! Arthur Burns, for example, was continuously pushed around by Nixon before his 1972 election.[1] This is Nixon exhorting him to be more forceful in pushing his colleagues toward interest rate reductions: "You can lead 'em. You always have. Just kick 'em in the [expletive deleted] rump a little." Nixon understood that the independent Fed needed a little forceful guidance from time to time. Greenspan also had his head metaphorically slapped by senators after his vision of "irrational exuberance" in 1996 as the S&P broke past the old 1929 record of 21 times earnings. The slapping was so effective that by 2000, at 35 times earnings, he had become a cheerleader for the new era. But of course we see only the tip of the iceberg through random Nixon tapes and public Senate meetings. The process must be continuous and hard to resist for any but the very strong of backbone.

The result that we can indeed measure is the very long record of the wonderful third year of the Presidential Cycle, when Presidents and administrations really want to be re-elected and really push for stimulus. Employment and GDP improve a little and the much more sensitive stock market a lot. Seventeen out of 19 Year 3s since 1932 have returned over 11% real versus 6.8% for the average year, and only two have been poor (one in 1946 as World War II ended and investors feared another post-war depression like 1919, and the other in 1979 during the oil embargo), a result that is statistically significant at the level of 1 in 10,000. The main cause of this (discussed in this quarter's Letters to the Investment Committee) is almost certainly more the encouraging tone of the Fed than dramatic monetary action.

This year was heading for the third worst Year 3 in 19 tries, and was only 4.4% real on August 16, with just 6 weeks to go, when the onslaught of liquidity from the ECB and the Fed started. It was still the third worst on September 18 with only 7 business days to go to the end of the presidential year, when the 50 basis points arrived and kicked it up to a 14.1% year. We wuz robbed! Although 14.1% was still far below the remarkable 23.3% average return – a small but welcome mercy.

For a short while I had touching faith that the more "academic" Bernanke would take a tougher line than Greenspan, and he did sound fairly fierce early on, but as

[1] Burton A. Abrams, "How Richard Nixon Pressured Arthur Burns: Evidence from the Nixon Tapes," *Journal of Economic Perspectives* (Fall 2006): 177-188.

the heat turned up he overcame any qualms and threw in the towel quickly enough.

Mervyn King of the Bank of England talked a very much tougher game than Bernanke, positively disdainful of the U.S. and the ECB pandering to the imprudent, over-extended financial community: "The provision of such liquidity support," he said on September 18 referring to the ECB and the Fed, "undermines the efficient pricing of risk … that encourages excessive risk-taking and sows the seeds of a future financial crisis." My kind of guy! But he too buckled under the combined weight of political and financial pressures and, additionally, he endured the public disgrace of the British enjoying an excuse to have a good old queue. The Brits embarrassingly have always showed such solidarity with the U.S. that since 1932 they have a third year U.S. Presidential Cycle effect in their market almost as large as ours: 22% real versus our 23.3%. It is a telling commentary on who calls the shots in the U.K.: it is not their completely independent central bank, but our completely independent central bank.

And why should we care? Because we agree with the Mervyn King of early September 18 and not with the Mervyn King of late September 18. And because, as we've written about before, we are engaged in a dangerous experiment to see how far the elastic band will stretch. The experiment in moral hazard is leading to a series of asset price bubbles, any of which might float out of control. The last bailout produced or at least enabled a housing bubble, and the one before – after LTCM, Russia, and the Asian crisis – produced the real McCoy: the tech bubble of 2000. Each bailout seems to be received with a quicker rally, and negative news is increasingly easily dismissed. The other day it was announced that UBS, Credit Suisse, and the dance champions at Citibank all had to take billions of dollars of write-downs, far more than would have been admissible in polite conversation as little as even 6 weeks earlier. This was celebrated as good news – "it's all behind us" – so the market rallied 2% for the day, back to its high! What will this new burst of liquidity moral hazard bring? Emerging markets would certainly be my preferred choice, and they are indeed shaping up well, having rallied a remarkable 33% since August 15.

So What Happened in the Third Quarter?

There was indeed a genuine severe credit crisis. Either the Fed and others were told some pretty dire things about the state of some major institutions or they are even sillier than I think. *The New York Times*, *The Economist*, and others all gave their opinion that some serious financial failures (worse than Northern Rock) must have been feared by the authorities to justify such early and powerful intervention. One can wonder how Countrywide and Northern Rock would have played out with no interference. Big chunks of the credit system had simply frozen. Risk premiums in fixed income widened very substantially in general, with a few exceptions. Liquidity premiums, not surprisingly, widened in particular. But, give or take a few down days, the equity market continued in denial. Perhaps in the short term they had a brilliant understanding of the lack of strength in the Fed's knees and in those of their European colleagues. Given the developments in the real world, the equity market's ability to close up for the quarter is truly remarkable. In the quarter, the housing market was in ragged disarray; corporate profits were okay, but growing far less than in recent years; the dollar was disturbingly weak; and the credit crisis had raged. So equities rally to a new high. Of course that is because it's a discounting mechanism! Let's consider what it is discounting: presumed continued dollar problems, almost certain housing weakness, slower economic growth in the U.S. and Europe, weaker estimated profit growth in the U.S., higher commodity prices (particularly agriculture), and more global pressures on inflation. Yes, I get it!

Where has the credit crisis left us other than with a carefree stock market? Banks are still not happy lending to other banks, and their rates for this, which surged in the crisis, are still not far from their highs. Mortgages are harder to get and will probably worsen. Leveraged corporate debt is still more costly, harder to get, and contains more careful provisions. On the other hand, credit default swaps, the indices of which doubled in a few days, have backed down 60%. The good news is that very probably the worst part of the crisis – the freezing of all lending – has passed. The bad news is that the reappraising of risk and other economic effects of the credit crisis will play out slowly over the next year or so.

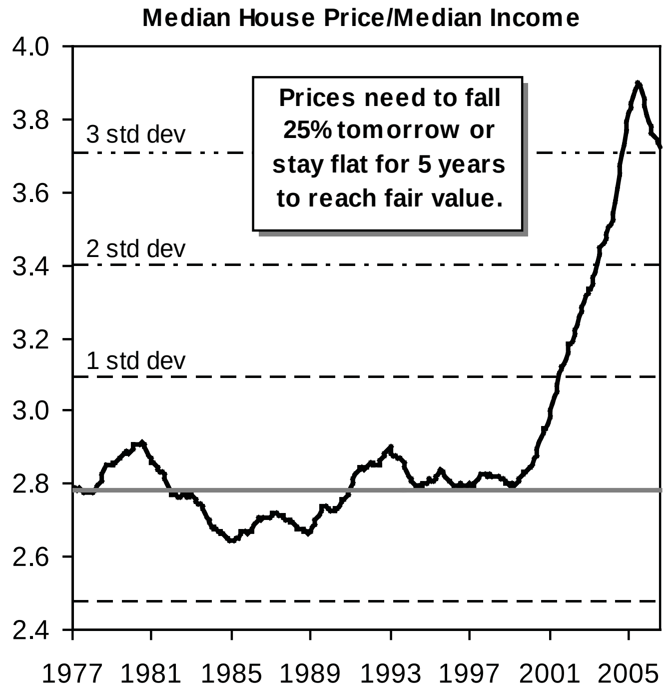
What Would You Have Done, Smarty Pants?

It's a difficult question. You couldn't allow the system to freeze, so even if you wanted to punish the wicked you had to let them off again. And 50 basis points – importantly with a unanimous vote and accompanied by massive liquidity injections from European colleagues – probably had enough positive effect on animal spirits to prevent what could have been a financial failure unprecedented since World War II. So the real question is: Why were central bankers forced into a corner where they had to reward reckless risk taking once again? The bad behavior goes back a long way. (See my 3Q 2002 diatribe on Greenspan, "Feet of Clay," at www.gmo.com.) It is embedded in how the recent Fed has seen its job description. Echoing earlier comments by Greenspan, Bernanke spelled out the problem in September 2004: "For the Fed to interfere with security speculation is neither desirable nor feasible," but "if a sudden correction in asset prices does occur, the Fed's first responsibility is to protect … to provide ample liquidity until the crisis has passed."

As you can see, they have made no secret about it. To let bubbles form unimpeded and yet to move to cushion the subsequent decline is a simple and workable definition of moral hazard. The fact that they define it as not moving to prop up asset prices, but only to cushion the economic effects of asset prices declining, is sophistry. It amounts to exactly the same thing. In contrast, The Bank of England, my former semi-heroes, have long maintained that it is appropriate for central bankers to be concerned with asset bubbles, knowing as we surely must by now how destabilizing they can be. Recognizing bubbles is held to be hard: "To spot a bubble in advance," said Greenspan, "requires a judgment that hundreds of thousands of investors had it all wrong." Greenspan has since contradicted this ridiculous comment many times when describing investor herding and irrational behavioral markets. And his great 2000 bubble, partly indeed his creation, peaked 65% higher than any previous market. Not only did it look like a Himalayan peak, but statistically it was a 3-standard deviation, 100-year event. Far from being hard to spot, it was impossible to miss. The current housing bubble (Exhibit 1) was also easy to see. The seeing part is easy, but acting is not. It is particularly dangerous to the careers of anyone involved. No Fed Chairman, as Galbraith said, wants to be the one caught holding the pin as the bubble bursts. The pain caused by intervention will be very visible, and the pain avoided by intervention, perhaps much greater, will always be hypothetical. For any normal Fed Chairman (Volcker was clearly abnormal, happily), this will always be an easy choice. But if you don't act to at least moderately restrain major asset bubbles – by all means ignore the medium ones; when in doubt stay out – then you will be backed into ever more corners and be forced to extend moral hazard

Exhibit 1

The Current Housing Bubble:
U.S. House Prices Will Decline



Sources: National Association of Realtors, U.S. Census Bureau, GMO
As of 7/31/07

until its ultimate Minsky moment where no intervention is enough.

Housing: Where the Trouble Began

I suggested in 2005 after a trip to Australia ("The Canary in the Coal Mine," 1Q 2005) that the U.S. housing market that was still in bubble territory (Exhibit 1) should turn down in a year because it was lagging the U.K. and Australia, and because it is so reliably mean reverting. For once I got this more or less right, and about a year later we had a first down month in some of the data. Multiples of family income are a simple and powerful controlling factor on housing. Exhibit 1 shows that we in the U.S. in the recent decline (in the Shiller series) have come down about a quarter of the way to usual long-term affordability. Just for the record, how does my beloved Fed stand on this issue? Greenspan in 2005 said there was froth in some real estate markets, but basically it was fine, and also infamously exhorted home buyers to use variable rate mortgages rather than fixed at a time when rates were near their lows, definitely his weirdest piece of advice. As for Bernanke, in October 2005 he claimed that advancing house prices merely "reflected strong economic fundamentals." Also in 2005 and slightly less cavalierly (but only slightly), he said on CNBC, according to *The Economist*, "We've never had a decline in housing prices on a nationwide basis. What I think is more likely is that house prices will slow, maybe stabilize." Look at Exhibit 1 for a second. The market was deep into a 40-year (2-standard deviation) bubble based simply on a long and relatively reliable price series and its volatility. What was he thinking? Do he and his assistants not look at long-term prices, or has the mean-reverting nature of house prices not yet revealed itself? More recently, as yet another example of immoral hazard, his fellow board member Frederic Mishkin argued that since housing prices were likely in his opinion to come down and probably by a lot (20% real), and since he believed the resulting damage to economic growth to be predictable, the Fed should act preemptively – even before any sign of economic trouble. We wonder, when house prices were roaring, why the reverse was not argued and rates raised preemptively to cool housing so that excesses of consumption, extended consumer borrowing, and extended subprime nonsense would not have caused such problems.

Where Are We Now?

Compared with what we might have guessed a quarter ago, today's outlook for the next year or two may be a little worse: the extent of the subprime problems in dollar terms, how broadly it spread its pain, how uncertain the holders of the debt were (and are) as to values, and the shocking lack of responsibility in issuing, assembling, and rating this debt were all worse than most of us feared, and many of us feared a lot. GMO's fear of economic slowdown at least a percent below consensus for 2008 has become more of a mainstream concern. Our general unease with the dollar has now increased and is very broadly shared. And for the first time in 20 years I am slightly worried about inflation. I have never dwelt on this subject in a quarterly letter, but now long-term intractability with commodity prices may be joined by rapid wage increases in India and China. By the way, like many others I have an increasing distrust in the official inflation numbers. For example, we have rising commodity prices and a very large deficit combined with a very weak currency, yet we have a decreasing inflation rate and one that is lower than that of many European countries with strong currencies. Very odd indeed and a good research project for us.

For the next few months, in contrast to the longer term, the general economic outlook may have improved a little because the unanimity and extent of the authorities' response to the credit crisis appears to have created some broadly based, if temporary, economic and financial faith that all issues are finely controllable by the Fed and others. This positive jump in animal spirits may actually help the real world as well as the markets, but probably not for more than a few months. (See Letters to the Investment Committee.)

Lurking beyond these current problems lies an interesting new inflationary problem with a very slow-burning fuse: the age profile of the developed world and China. There will be a steady shift in age cohorts with the cohorts of the new workers beginning to decline and those of older workers and retirees increasing. After the Black Death there were more agricultural and urban "plant and equipment," cleared fields to be planted, etc., than there were workers, and it ushered in by far the best 100 years for workers' pay and income redistribution for hundreds of years on either side. From now on, slowly but surely and with less pain than the Black Death I hope, the generally favorable labor patterns of the post-war period will deteriorate. Workers will carry more retirees, graduating classes will be smaller (Japan, leading this charge, is already running down well over 10% from its peak), and there will be steady upward pressure on wages, other things being approximately equal, which no doubt will be welcomed by new workers whose hourly pay has languished in the U.S. for decades. GMO will be looking at this situation and trying to assess its implications for markets, particularly housing and equities, over the next several years. Provisionally, it looks quite bad for inflation and for the supply-demand position of both real estate and equities.

Some Near Certainties in Uncertain Times

I wrote 800 words for *Fortune* magazine a few weeks ago, before the 50 basis points ("Danger: Steep Drop Ahead," 9/5/07, www.fortune.com). In it I argued that the three things that mattered most to me at the time horizon of 3 to 5 years (the period I'm most interested in) were near certainties and not dependent on whether the credit crisis was stopped in its tracks or was left more or less to run its course. First, U.S. house prices would continue down toward trend over the next 3 years or so, and accordingly mortgage defaults would rise, mortgage re-financings would fall, and all of this would cause a steady drag on consumption, profits, and GDP growth. Second, profit margins would decline globally with negative consequences for stock pricing. Third, risk would be re-priced on a very broad basis so that some time in the future we would see, once again, a normal or above-normal premium for high quality stocks and bonds. If the crisis were not contained these effects would occur quickly, and if it were contained they would occur slowly. Now, a few weeks later, I would argue that the workings of the credit crisis – it was more savage than I expected but countered more aggressively than expected also – have left us about in the middle ground: the occurrences of the third quarter have worked to moderately speed up the progress of these three nearly inevitable factors.

My view since March was that a crisis was certainly developing and was more clearly flagged than other important financial events I could remember. However, my "very slow motion train wreck" was not a very accurate description. "Train hits end of track at full speed" would have been more like it, perhaps with the sub-heading, "Several killed and hundreds hurt, but survivors showered with government aid."

Recommendations

No surprises here. For any but the very nimble players of musical chairs and the experts at Keynes's beauty contest, of which there are clearly quite a few (lucky people), we recommend continued extreme caution. The best hedge against the career risk of being too conservative remains emerging market equity, overpriced but still attractive on a relative basis.

Forecast for the Next 12 Months

To keep it simple, we will use just two variables: the Presidential Cycle and value. Is the market in the expensive half or the cheap half? For the record, the presidential year just ended was an "expensive" Year 3. (As mentioned, since 1932 these have averaged a remarkable 23% real. The actual return was 14.1% real.) We are now in Year 4, famous for its super normalcy including its remarkable lack of outliers, heroes, or villains. This is an "expensive" Year 4, and the average since 1932 has been 3% real versus 12% for "cheap" Year 4s. I guess I would happily settle for 3% whilst waiting for the more interestingly bearish opportunities of 2009 and especially 2010. In the meantime I believe global equity markets will struggle to resist going down. Animal spirits have had years of reinforcement from great fundamentals and a friendly Fed, and will not readily abandon ship even though the tide of positive fundamentals has clearly turned and is slowly ebbing: global GDP and the U.S. GDP are both slowing, U.S. profit margins are forecast to decline, and inflation is threatening more. A modest up year, with a mixed return to risk-taking but strong emerging market performance, would be my guess. And in the U.S., a small gain might easily be the result of a higher P/E on moderately lower earnings. Any <u>major</u> bearish behavior is likely to wait for another 12 or 18 months, but accidents do happen, and it should be remembered that the value of the U.S. market based on a normal P/E of normal profit margins is over one-third lower than today's price.

P.S.: A Perma Contrarian Uncovers an Archive

Most regrettably we contrarians missed out on our real opportunity to be outrageous bulls in the 1930s, but I for one did at least catch all 13 years of continuous under-pricing of equities in 1973 to 1986 after the fall of the Nifty Fifty. We at GMO did not get to say much in those early days, but I recently rediscovered the only quote in black and white from GMO's entire first 10 years, and I must say it would warm the cockles of any contrarian's heart. The June 28 issue of the *Portfolio Letter* in 1982, the year in which the market hit 8 times depressed earnings and the lowest price to replacement cost in 50 years, quoted me (deep in the issue) as saying, "…that the market was approaching '<u>a major rally, perhaps the biggest in a decade</u>,' and that our firm's cash position was 'nil.'"

And just to be mean, since I have the yellowing copy out on my desk, it also quoted Leon Cooperman, the predecessor to Abby Cohen as the Goldman Sachs strategist (of course on the front page), as saying, "…now is not the time to make any major commitments to stocks … for the foreseeable future." Sorry Lee, I'm sure you changed your position by August.

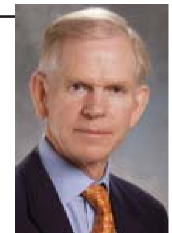
Stop the Presses: A Convenient Recognition

I had a rant on the lack of U.S. environmental policy last year (4Q 2006 Letters to the Investment Committee) to discretely tout Al Gore's movie. The movie created a much needed wider awareness of the U.N.'s report and the U.K.'s Stern report, which both followed shortly thereafter. Fortunately for public awareness, there were also some startlingly heavy scientific reports on how much faster northern ice was melting than the consensus of 2,000 scientists had indicated in the U.N. report. (Can you imagine what it takes to get 2,000 scientists to sign off on anything? The Earth is round, perhaps? So this conclusion that temperature increases were 90% likely to be caused by us actually reflected the 2,000th most conservative view; the median view was almost certainly 99%.) Well, now after an Oscar, he gets the Nobel Prize! An interesting pair of trophies. And the well funded, anti-science, "nothing is certain and the science is bad" faction is finally in ragged disarray. I normally admire contrary thinking, but it is one thing in a herding marketplace. In science, particularly in our world that really doesn't like bad news, contrarians can easily produce a smoking-doesn't-cause-cancer and the-climate-future-can't-possibly-be-that-bad perspective. But it now looks as if we will take climate change seriously. In this case, climate change and energy efficiency will be a giant investment area. And no doubt it will be full of interesting bubbles, of which, perhaps, boondoggle ethanol is the first of this new cycle.

GMO

SPECIAL TOPIC

October 2007



*Letters to the Investment Committee XIII**

Troubles with Economics: The Fed and Animal Spirits

Jeremy Grantham

Like the drunk looking for his keys under the street lamp because that's where he can see, economics not surprisingly focuses first on what can be easily measured. As the topic becomes broader and longer and approaches philosophy, human foibles, or personal taste, economics analysis often comes up short, telling us for example that the world that brought us the '87 crash and the internet bubble is efficient, with all data processed quickly and completely and dispassionately. "Dismissing financial crises on the grounds that would imply irrationality is to ignore a condition for the sake of a theory"[1] is how the economic historian Charles Kindleberger dealt with this nonsense, which is no doubt still heading for a Nobel Prize!

Another recent good example of the limits of economics is found in the attempt to do a cost/benefit analysis on climate change and its mitigation. The future pain likely to be incurred by human-induced warming involves trading off the well-being of future generations against our own, for which standard discount rates result in the ludicrous conclusion that the distant future simply doesn't matter (grandchildren are less important than grandfathers).

An even better illustration might be found in attempting to measure the costs to the U.S. of World War II. Standard economic analysis can grapple in minute detail with the prodigious diversion of resources into assets like battleships and planes that are simply destroyed. The costs of training and supporting a large military force and the opportunity cost of not having them work in normal jobs that increase the general welfare were measurable and were waste indeed. But if you take a step back and define the broadest measures of progress, you get a substantially different picture. From 1940 to 1946 U.S. GNP rose substantially faster than normal. The poor were employed, well fed, and housed to a degree never seen before. General health improved and education continued. You might answer that this apparently happy state was arrived at only by War Bonds – passing the costs on to future generations – and indeed the government debt to GNP rose from 0.5 to 1.2. Yet the next 10 years, when theoretically the piper was being paid as the debt was paid back down, the U.S. again grew above averagely fast and continued to do so for another 10 years. When the smoke cleared, the period 1940 to 1965 (and all the 5-year sub-periods within it) could be fairly described as the economic golden age of the 20th Century and perhaps also the golden age for improvements in general well-being. It appears, contrary to the idea of a costly war machine, that World War II increased the wealth and annual wealth-generating capabilities of the U.S. In that sense it had no economic cost, perhaps even the reverse, despite the terrible human cost it had on those directly involved.

This difference between the long-term measurable consequences and the apparent short-term effects set me to thinking about some of our recent financial questions. The most important of these for me is the role played by debt. Debt is seen in general as an economic "good" these days and is widely considered the short-term driver of the rate of economic growth, fine-tuned through interest rates. Interest rate changes would appear to have no effect unless they induce changes in borrowing. Thus it is assumed that lowering the rate encourages increased borrowing that in turn encourages, on the margin, increased economic activity, higher profits, and higher GDP growth. Since the Fed controls the short-term government rates, it can be

* The Letters to the Investment Committee series is designed for a very focused market: members of institutional committees who are well informed but non-investment professionals.

1 Charles Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises* (Wiley, 2005).

seen as the driver of this debt fueled vehicle, and such is the power of changes in debt (or so it is believed) that no recession ever has to occur and the economy can proceed with little volatility.

To repeat the World War II experiment, we can step back and look at the total debt to GDP ratio for many years so that all of the short-term optical illusions drop away. There has been a substantial increase in the total of all kinds of debt added together. Exhibit 1 shows that total debt has increased from $1.30 of debt per $1 of GDP in 1980 to over $3.10 of debt per $1 of GDP today, more than a doubling in 25 years. Since most of this debt represents what one American chooses to lend to another, this increase is not necessarily bad. There are obviously no hard and fast rules about how much is too much, although Hyman Minsky has suggested that at some level some borrowers will be borrowing not only to repay principle but also to pay interest, so that occasional credit crises will occur and probably with increasing frequency as debt ratios rise. Each in turn, though, may be cured, it is now believed, by applications of more debt, more liquidity, and more moral hazard. The hair of the dog that bit you certainly applies today where a problem previously caused by too much debt in the wrong hands will apparently be cured by lowering rates to increase marginal borrowing. This is like the alcoholic's "Bloody Mary plus" on Monday morning after the Sunday night bender. It may clear his head for the big meeting, but is not much of a cure for his incipient cirrhosis of the liver!

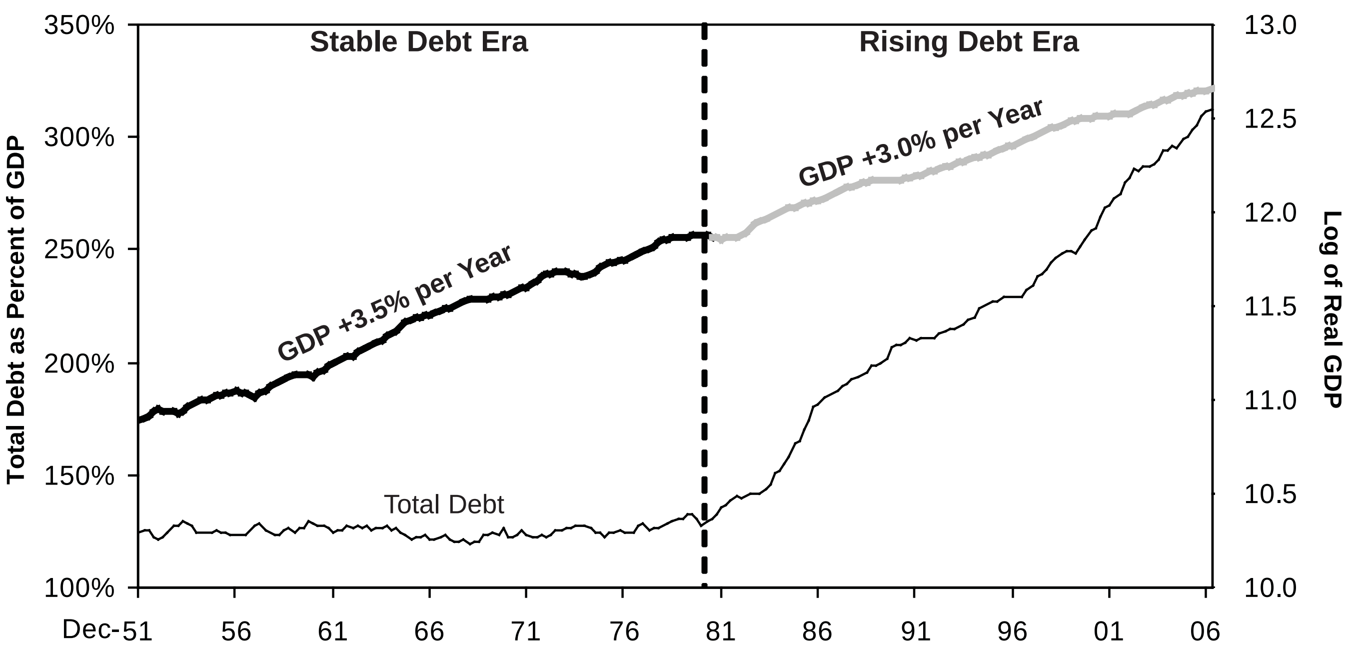
With care the system will probably cope with significantly higher debt/GDP ratios, at least for a while, and I would bet that we are heading in this direction.

But back to business: Exhibit 1 shows the U.S. GDP battleship at full steam, with its remarkable ability to stay close to its over 100-year trend of 3.5% real growth. Check out first what I said about World War II and the debt overhang period following. It is indeed clearly above average. Now look at the period since 1980. Despite a doubling of the debt ratio, there is no acceleration at all in the growth rate. Further, despite an increasing growth rate of debt since 2001, we seem in fact to be tailing off from the GDP trend. This fall-off in GDP growth is happily a very pale shadow of the Depression, but it is now the runner-up for the worst decline below trend. Now if debt is so potent a force, why is its potency missing in aggregate? The data seem to support a view that debt is irrelevant to longer-term growth, which is presumably a function of hours worked and productivity increases, which in turn are a function of capital invested and innovation in how the capital is used and organized. Lending to each other would not seem to measurably change these inputs.

In dazzling contrast to this theory, the market recently rose 5% in 2 weeks following the 50-basis-point rate cut,

Exhibit 1

Debt Growth Has Unusual Effect On Long-Term Fundamentals: None!



Source: BEA As of Q2 2007

and did so unaccompanied by any other surprisingly good news such as employment, profits, or growth rates. If anything, the accompanying news was negative: billion dollar write-offs, a sliding dollar, and reduced profits and GDP estimates for the next 12 months. So presumably the 5% market rise was really a function of the 50-basis-point decline. Now, wait a minute! The market was betting 50/50 on 25 or 50 basis points or so, the futures markets suggested. So we can say fairly enough that the market rose on an unexpected 15 basis points or so. And on this pillar was based a 5% increase in the long-term discounted future value of the entire U.S. corporate sector. Not bad. Looking past the rate reduction, the market move was really based on the incremental borrowing that would be induced by this unexpected 15 basis points, and beyond that on the economic stimulus and increased corporate profits that would result from that tiny incremental debt. Yet historically there is no such effect at all even from a massive increase in debt, or at least none that can be seen in the long-term data.

Perhaps the Fed's foot on the pedal, lighter or harder, can indeed move the short-term, say, quarter-to-quarter economic growth, although it seems odd that by facilitating debt expansion it would move the short-term economy, but not the long-term, since a series of short-term effects would appear to equal a longer-term one. But let's say it can. The trouble is that a rational pricing of the stock market covers its long-term value, not its short-term twitches.

(And this whole argument so far has been based on a supposition that the Fed can indeed drive this machine. Jim Grant, who is given to questioning rather than faith, has argued many times that the Fed's management of the interest rate is simply price fixing, and hasn't the Soviet Union established once and for all that price fixing and government direction in economics is a poor substitute indeed for a free market? He also reminds us that it is normally considered that you can fix the price [the interest rate] or the quantity [liquidity level] of any commodity, but not both. Yet the Fed uniquely is given credit for pulling off this trick.) However, while I suspect Jim Grant is right, even if the Fed does have these remarkable powers and is indeed the driver, my point is that for longer-term results it appears to be irrelevant: debt management and the quantity of debt simply do not affect long-term growth or the fundamental value of the stock market.

We can come to the same point with the Presidential Cycle effect. We know why the administration would like to stimulate the economy and particularly employment numbers in the last 2 years and we know the Fed is the key, but we don't know how they pull it off! How does employment get to rise in Years 3 and 4 and why does the market respond so heroically in Year 3 to this process? The change in the obvious suspect variables of interest rates and money supply does not appear to change enough to move a tugboat, let alone a GDP battleship. No, common to the presidential puzzle and the debt puzzle are <u>animal spirits</u>. What moved the market up 5% in 2 weeks was not the 15 basis points. What appears to move employment a small but critical amount in Year 3 is not textbook financial stimulus. In both cases the Fed plays a key role in improving animal spirits, which are very sensitive to short-term events and short-term statements. It is not so much that the Fed <u>delivers</u> in Year 3 as that it <u>promises</u>. The Fed suggests the market can speculate more in Year 3, and if something goes wrong it will bail us out. And moving the short-term interest rate, accompanied by suitable jaw-boning carefully selected comments – at which Greenspan was so good – is their main weapon in changing animal spirits. <u>As long as the market believes</u> interest rate reductions and favorable body language have a real effect, they will have a short-term effect <u>even if they are irrelevant in the long term</u>. And this effect – animal spirits – will be much more observable in short-term market moves than in tiny changes in short-term fundamentals because in the short term, changes in animal spirits are nearly everything in the market and have certainly washed away better men than me. But in the long term, misplaced faith in the Fed cannot create new technologies, raise educational standards, improve working practices, or accomplish any of the things that really matter.

Meanwhile, for short-term market prices, the touching faith in the Fed blends nicely with Keynes's view of markets and the beauty contest: for heaven's sake don't waste your time trying to work out what the Fed's moves really mean, or corporate write-downs of subprime debt, or changes in employment numbers: work out what other investors, particularly the hair-trigger hedge funds, will make of it and anticipate them if you can. It's not how we manage money, but it sounds like a whole lot of fun!