MARKET LETTER

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Mustard Seeds, Minsky, and "The Great De-cession"

By Dean M. Dordevic

"Tom Burke is a great energy innovator from Britain. He invented a unit of measure. He calls it the 'Americum.' And an Americum is any 300 million people in the world living like Americans. Well, when I was born in the '50s, there were only two and a half Americums in the world. There was America, Europe and Japan. Today there are nine. There's one in America, there's one in western Europe, there's one in eastern Europe and Russia, one in India, giving birth to another, one in China giving birth to another, one in Japan, east Asia and one in South America…"

Thomas L. Friedman[1]

The news is just so very bleak and voluminous that it could easily fill a few pages of this piece alone. Hedge fund manager Doug Kass described quite fittingly the current malaise as a "De-cession." Since he offered no specifics, our interpretation denotes a fairly deep recession, coupled with a significant overhang of debt, countered by an enormous asynchronous monetary and fiscal response from governments and central banks across the globe (acting as a shock absorber). To the extent that we can summarize: interest rates have dropped to almost zero, bank stocks have plunged by 90 percent in many cases, the Federal Reserve's balance sheet has ballooned, credit spreads have widened to historic levels, the global economy is experiencing what amounts to a synchronized margin call, unemployment is rising, and manufacturing activity has fallen off a cliff. Note: this is only a partial list.

It seems to us that we're experiencing a three-act play. The end result will be a return to some degree of "normalcy." Or more likely, "the new normal" as it has been called. The first act has two parts; like a sail boat that's been knocked down, we're waiting for the keel to do its thing and right the banking system. Once complete, we then expect the economy to stabilize too. At a minimum, the rate of decline in economic activity needs to abate. While the market will discount recovery well in advance of its actual arrival (by some six to nine months), there will be a period (perhaps reasonably protracted) of "reflation." This is the second part of the play.

Since there has been so much monetary (and fiscal) stimulus injected into the global financial system, at some point (when the so-called Keynesian "animal spirits" return) the economy will heat up and so might inflation. The extent to which we reflate will be at first most welcome, since it will signal that any tendencies toward deflation will have been either greatly reduced and/or extinguished. However, this reflation could morph into inflation and become problematic at some point. We could potentially experience an episode of fairly virulent inflation as a result. The extent to which this becomes a problem will be a function of the skill and expert timing of global central bankers and their ability to "vacuum" excess liquidity from the financial system. It would be naive to assume that this will occur without unintended consequences or some degree of macroeconomic difficulty. What we do know is that central bankers are well aware of the high-powered money they have injected into the system and the likely outcomes resulting from their actions—but this is not today's problem.

The third act of this play is perhaps the most interesting, principally because it will be the longest lived. The economy of the last three decades has resembled a 10-speed bicycle. That is, we geared the bicycle so

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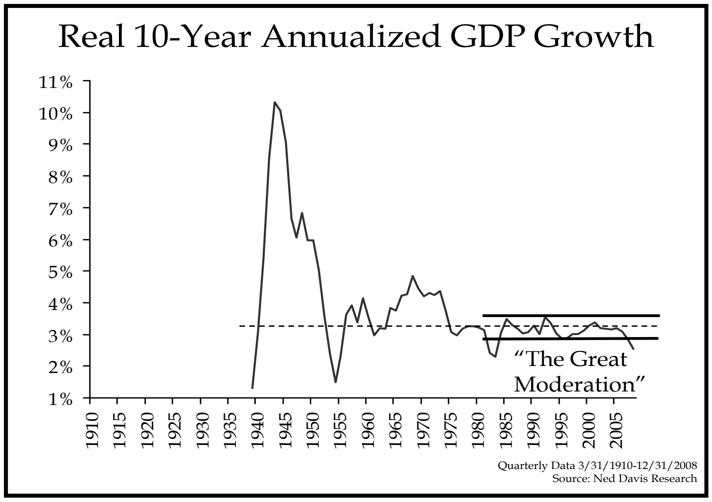


Real 10-Year Annualized GDP Growth

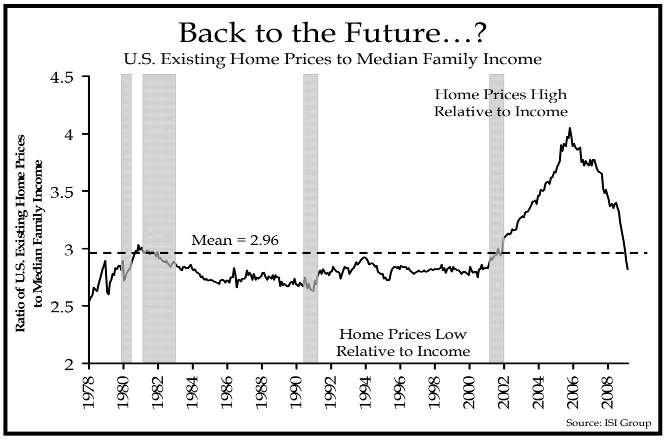
that when we turned the crank, the rear wheel revolved about 30 times. In other words, the gearing (or leverage) in the financial system supported roughly 30 dollars of debt for every one dollar of equity. We are now rapidly moving to a new and more conservative gearing of the system. It is far more likely that the financial system will be geared so that with one turn of the crank, the machine will produce only eight, ten, twelve or perhaps fifteen revolutions of the wheel. This will "feel" very different. The economy will grow more slowly, and we will go through an extended interval where the supply of goods and labor will inevitably reach a new level of equilibrium. This process is now in full swing, resulting in a painful, unavoidable and ultimately desirable outcome. This adjustment will take years, not months.

There is another important underlying theme, once virtuous, that has now turned somewhat vicious. It has received a good deal of attention in financial and academic circles, but in our view not nearly enough general exposure when considered relative to its importance both now and going forward. In his 2004 remarks entitled "The Great Moderation," Ben Bernanke spoke of the changes to the economic system that were at once profound and powerful:

> "One of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility. … The variability of quarterly growth in real output (as measured by its standard deviation) has declined by half since the mid-1980s, while the variability of quarterly inflation has declined by about two thirds. Several writers on the topic have dubbed this remarkable decline in the variability of output and inflation 'the Great Moderation.' Reduced macroeconomic volatility has numerous benefits. … Lower volatility of output tends to imply more stable employment and a reduction in the extent of economic uncertainty confronting households and firms. The reduction in the volatility of output is also closely associated with the fact that recessions have become less frequent and less severe."[2]

We have just exited one of the longest periods of moderate and sustainable economic growth on record. We have witnessed a series of back-to-back economic cycles that were remarkable in their durability. They were also, from virtually any historical perspective, reasonably benign. The turmoil we are experiencing has brought to light the thinking of an economist named Hyman Minsky (1919-1996). Minsky said that the structure of a capitalist economy becomes more and more fragile during periods of prosperity.[3] In other words, the longer the period of uninterrupted growth, the more fragile the system becomes, he argued. Minsky dubbed this the "financial instability hypothesis": stability breeds its own instability. As a practical matter, the marginal propensity of a business or a household to consume or invest increases if it is believed that tomorrow will look substantially like the past. We are very much experiencing a "Minsky hangover." Very simply, we accumulated too much "stuff" as we became somewhat inured to the business cycle which, as Bernanke pointed out, had become so very tame.

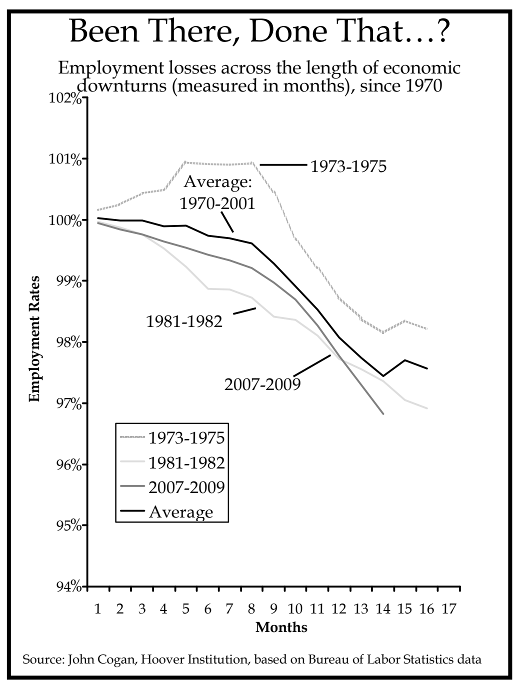
Is there any good news? As CNBC's Larry Kudlow so often asks, "Where are the mustard seeds?" There is certainly some good news. To be sure, it gets less press ("if it bleeds, it leads"), but nevertheless the market has fallen dramatically and has discounted quite a bit already. The banking system has shown some nascent signs of stability, cash in money market funds now exceeds 40 percent of the stock market's total value



(an all time high), and corporate balance sheets are flush with cash. As *BusinessWeek* recently quipped, "cash is the new black."

However, there are many who believe that this problem began with housing and will end with housing. That's a reasonable assumption in our view, and there is some good news to report on that front. History has shown that when bubbles burst, governments can change the trajectory of the decline, but usually not the endpoint. As the chart to the left shows, homes became supremely unaffordable (relative to median family incomes) in 2006 and 2007. However, as you can see, home affordability has now reached the mean value of about three times median family income (dating back to 1978). This is an encouraging sign.

It is also encouraging to see that the savings rate has soared of late. While this is a two-edged sword (since its inverse, an overly-rapid decline in consumer spending, could be calamitous), this increase is welcome in our view. While consumers are saving more, they are simultaneously cutting their debt burden. In fact, the third quarter marked the first decline in household debt since recordkeeping began in 1952. Unfortunately, unemployment appears to be tracking the two worst recessions of the past 40 years, which is something we are watching carefully. The important point here is that we've experienced unemployment of a similar order of magnitude (when compared to the worst recessions) and have recovered. As an editorial in *The Wall Street Journal* recently pointed out, "... So far at least, the current downturn, isn't much more severe than the average of all recessions since 1970. This month the downturn turns 15 months old, which is one month less than the recession of 1981-1982, though job loss hasn't yet been as severe. Many Americans may have forgotten those nasty recessions because the last two (1990-1991 and 2001) were only eight months long and shallow..." [4]



While bank stocks were crushed during the first quarter, there are some encouraging signs of improvement that appear to be unfolding. An awful lot of the problems in the banking sector revolve around the issue of "mark-to-market" accounting. By way of example and in very simplistic terms, under the current rules: if your neighbor loses her job and her home goes into foreclosure, the bank sells the home for (let's say) 50 percent of its value. For regulatory purposes, your home is now worth the same. Even though you are still gainfully employed and current on your mortgage, your bank must now write down the value of your home too. The problem with mark-to-market is that it is just fine for disclosure purposes, but horrible for regulatory purposes. It forces banks to raise capital or sell shares at ridiculously low prices to meet the regulatory standard. Regulators can be forced to treat an institution as insolvent, even though their assets (loans) continue to perform. None other than Warren Buffet spelled out the illogic resulting from a lack of regulatory forbearance; it is "gasoline-on-the-fire in terms of financial institutions." Making matters worse, in July 2007, the SEC eliminated the so-called "uptick rule" (created by FDR in 1938), essentially turning a blind eye to "naked short selling." Said Steve Forbes, editor-in-chief of *Forbes*

Magazine, "...Short sellers quickly saw how mark-to-market made seemingly invincible companies vulnerable to destruction. They picked their targets and relentlessly sold financial stocks short..." The good news is that it now appears that the new administration is moving with some urgency to end this cycle of lunacy.[5]

Americum to the Rescue?

We had the great pleasure of attending a recent lecture by Tom Friedman, *New York Times* Pulitzer Prize-winning columnist and author. Friedman is always thought-provoking; we read his books and articles with great interest and his opening remarks were most striking. He reminded us that there are not two-and-a-half Americums, as there were in the year of his birth, but now nine and more on the way. It strikes us that the growth that will come from these geographies is mother of all mustard seeds. Our pre-recession economy was driven in a reasonably significant way by global growth. We've even learned that the moon shot in oil prices of last year was really not so much a function of "evil speculators" but market forces principally from the developing world (note: there were no Congressional hearings accompanying the recent quote for crude of $35/bbl!). The desire of so many around the world to live more like Americans has not gone away. Collectively the emerging world now contributes 35 percent to global GDP, which is greater than that of the U.S. at 25 percent. This is a juggernaut that was waking, but has now hit the snooze button.

Listening to Friedman, we found ourselves mentally cross-referencing his excellent deep thinking with our own empirical observations in the global financial markets of late. By our lights, there are some mustard seeds here too. It is interesting to us that the Chinese market has not made a new low since last November. Oil has shown some signs of stability and has risen in price. The currencies of some of the countries most closely tied to commodity exports, like Canada and Australia, have held their lows and appear to have turned for the better. It's too early, in our opinion, to draw any solid conclusions from these data points, but nonetheless we will monitor our instruments in these diverse markets with great interest.

The turmoil from the global financial crisis that has reverberated around the globe will produce changes that are profound and long lasting. The road ahead will be bumpy and forecasting will be especially difficult. But we are reasonably certain that our view is sound and will help us manage effectively and make changes when necessary. At the moment we remain in a cautious posture both with respect to our overall asset allocation and stock selection.

A painful "De-cession" is upon us, "the Great Moderation" is now over, but there are mustard seeds all around us.

Sources and Footnotes:
Ned Davis Research - Charts.
[1] Thomas L. Friedman, author of *Hot, Flat and Crowded* – Speech.
[2] Ben S. Bernanke, "The Great Moderation." Remarks at the meeting of the Eastern Economic Association (February 20, 2004).
[3] Frank Shostak, "Does the Current Financial Crisis Vindicate the Economics of Hyman Minsky?" *Mises Daily*, The Ludwig von Mises Institute (November 27, 2007). http://mises.org/story/2787
[4] "The Obama Economy, Cont." Editorial. *The Wall Street Journal*, March 6, 2009: A14.
[5] Steve Forbes, "Obama Repeats Bush's Worst Market Mistakes." *The Wall Street Journal*, March 6, 2009: A13.

In Closing

During the difficult economic times we have all been experiencing, unpredictability has become the norm and bad news greets us more frequently than we would like. These times have prompted our reflection on the relationships we have as we navigate through these unprecedented waters together.

Whether you are a client or a professional we work with to serve our clients, we want to express our appreciation in the trust and confidence you have in our firm. Although recovery will take time, we are hopeful the worst is behind our nation's economy, and we are on the path to stability and growth in the capital markets.

In the past six months, we have seen an increase in media inquiries and groups asking our investment team to share their perspective on the economy and the capital markets. If you are seeking a resource on these issues for your firm, a board meeting or any organization you are involved with, please do not hesitate to contact us.

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