

# C *Economic & Market* Commentary

## Once in a Blue Moon



The phrase, “once in a blue moon” is used to describe things that don’t occur very often, and the phrase “black swan event” describes rare and impossible to predict events. The latter has been commonly used to describe the ugly 15-month period from December 2007 through March 2009. It was fitting that a New Year’s Eve blue moon, an event which won’t be repeated until 2028, closed out a tumultuous 2009. Starting in the Bush II administration and continuing in the Obama administration, policy makers made the biggest financial bets in history in an attempt to save the global financial system. The S&P 500, after being

down more than 25 percent through the beginning of March, gained more than 20 percent in 2009 (up almost 70 percent from the March 6<sup>th</sup> low), reflecting less fear and a budding optimism that the worst is behind us. Consumer and investor confidence has turned around, but the S&P 500 remains 20 percent below its year-end level of 2007.

Neither the economy nor the markets is as stormy as in March, but it’s not all blue skies ahead either, as the Federal Reserve (Fed) will begin draining the punch bowl near the end of March. The Fed has telegraphed its timing well, but how liquidity is drained from the system and how it is coordinated with other political objectives will determine the economic landscape. There are a few periods in our economic history that have similarities to the current situation. A common thread is the amount of capital that banks want to keep on their books. In the mid 30’s, the Fed viewed the excess reserves held by banks (funds available for lending) as gunpowder that could explode the money supply and ignite run-away inflation. To control this situation, the Fed doubled the reserve requirement during a nine-month period in late 1936 (thereby reducing excess reserves). In response, banks drastically cut lending from already anemic levels, to return to the level of excess capital they desired (higher than the newly raised minimum). As a result, stock prices fell 58 percent, employment rates fell dramatically, and industrial production fell 30 percent. Avid readers of the *Commentary* will note that this scenario was discussed in our March 2009 issue, which outlined the power of policy makers’ actions with respect to the economy and markets.

Policy makers across the globe did a fantastic job of avoiding the “Great Depression II.” Despite the Washington circus act where it became apparent that a number of our elected officials did not fully understand the magnitude of what was unfolding, nor the magnitude of what was needed to keep the system from imploding (most taxpayers still don’t), a lot of taxpayer money was committed and – bottom line – it worked; the system did not melt down. All that is left is the requisite back-patting and finger-pointing to make things right with the voters.

In that same *Commentary*, we highlighted that in 1936 the economy was climbing out of the Depression, that balanced budget discussions, combined with planned stimulus reductions, were leading to less Government-induced economic activity, and that banks were cautious lenders. While the Fed was concerned about inflation, banks were fearful of a double-dip back to depression levels, and wanted to keep liquidity levels high to protect their businesses and shareholders. Turn the calendar ahead 75 years and we are seeing a similar situation. We have a convergence of events ahead of us: the government has planned monetary stimulus reduction, and major banks are repaying federal dollars that they were forced in 2008 (reducing excess reserves) to avoid draconian government controls, while fearing continued and increasing loan defaults. This is compounded by the additional planned federal spending to fund the new health care program and a scheduled tax increase in 2011. The revenue to pay back federal funds borrowed for stimulus programs or health care programs or for repairing the balance sheets of many states and municipalities has to come from somewhere . . . the scheduled tax increase for 2011 may just be the tip of the iceberg.

Absent the power trip in Washington, banks might not have repaid the federal government so soon, which would have resulted in higher excess reserves and potentially more lending, leading to more of a “V” shaped economic rebound in the short-term. The one silver lining in this may be that some of the liquidity in the system that economists fear will fuel inflation is now out of the system. But new lending remains anemic as de-leveraging continues to run its course, keeping a lid on economic activity.

2010 should be an interesting year. A few countries, sensing an economic rebound in the air, have raised short-term interest rates to mitigate the risk of future inflation. Determining what information is typical political jawboning and what information is factual will give one a leg up this year. We hear the siren song of “continued low inflation” from policy makers, but are also cognizant of the 30 percent rise in the CRB commodity price index over the past 12 months. It is hard to imagine U.S. Treasury bond interest rates dropping further with an economy on the mend and commodity prices rising. The “bond market vigilantes” took interest rate justice into their own hands and drove longer-term interest rates a bit higher at year-end, despite the low inflation rhetoric. Could they be on to something?

The elephant in the room of any investment discussion is the strength and staying power of the Chinese economic engine. Exceeding growth estimates year after year, China has surpassed Germany to become the world’s largest exporter, surpassed Japan to become the second largest stock market ranked by market value, and has likely surpassed Japan to become the world’s second largest economy as well. Economists vary on the forecast of when China’s economy will match that of the United States, but it seems to be more a question of when rather than if... While China is the lead dog in terms of global economic growth, other emerging economies across the world have combined to be the growth engine for the rest of the developed world, and rebounded far better than most developed country’s markets. We intend to bring this economic growth into client portfolios whether it is through direct investment in those economies or indirect investment through domestic companies with significant stakes in the emerging economies.

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