

# INVESTMENT QUARTERLY

## PUSHING ON A STRING

Economist John Maynard Keynes coined the title phrase years ago when discussing attempts at economic stimulus by the government. When we push on a string it goes nowhere. All it does is pile up in front of us no matter how diligently we approach the task of pushing. In light of the current economic situation it is appropriate to dust off this old phrase as we examine the success or lack thereof of the current strategy to reinvigorate the sluggish economy.

Our analysis continues in the same questioning mode that we have followed since the US and world economies imploded in 2008. Despite the political rewrites that predominate the pundits' analysis of the cause and cure of our economic malaise, we believe there are very straightforward yet complex causes for our current situation.

The primary cause of the collapse was an overleveraged economy. Overleveraging allowed pricing bubbles to develop and created an overheated market place fueled by easy credit and concerns that profit opportunities would get away from us if we didn't act immediately. Despite populist finger pointing at the financial industry and greedy yield seeking investors, the conditions that allowed the worst economic melt down since the "Great Depression" started with the government, the Federal Reserve, and regulators. With more control in these three entities most, if not all, of the downstream misbehavior would not have had the fuel to reach incendiary levels. Government, read Congress, strongly emphasized pressures to extend credit to parties that could not safely meet the requirements necessary to support their debt. The Federal Reserve failed to use their powers to control leverage by increasing margin requirements and kept interest rates low, thereby making increased leverage affordable. Regulators failed to reign in the leverage of the investment banks, allowing their financial structure to incorporate unprecedented levels of leverage. And if the leverage itself wasn't threatening enough, the quality of new investment products reached an all time low as no money down and undocumented loans became the standard in the world of inflated real estate values. All this leverage created an overheated economy and easy borrowing made it even easier to increase spending to keep up with the Joneses.

Now we are still faced with the inevitable deleveraging that follows a period of over-borrowing and over-spending. It is hard to grow an economy that is deleveraging as demand decreases without the extra stimulus of borrowed funds. When you couple deleveraging with high unemployment you have to look far and wide to find pockets of increased demand. Not only are consumers restrained in their ability to borrow for consumption but they are also concerned about job security and making ends meet on reduced income from salary reductions or required unpaid furloughs. Taken to the extreme, this could potentially lead to deflation, a concern of the Fed and other policy makers.

The government has tried to provide stimulus through TARP loans to the financial industry, Cash for Clunkers for the automotive industry, and sizeable tax credits to help the real estate industry. The fact that none of these plans has moved the economy forward speaks not only about the size

of the problem but shows a different aspect to solving the problem. Money pumped into the banks didn't make it out the door into loans because the banks were fiercely under capitalized as the investments supporting their capital dramatically declined in value. To make loans would have put them in conflict with the regulators as they needed to reduce leverage rather than extend it further. The automotive industry saw no follow through after the stimulus payments ended and real estate is barely breathing after the tax credits ended according to our friends in the business.

How can this be happening when the budget deficits have reached gargantuan levels and look to continue to run at over a trillion dollars next year as well? In addition the Federal Reserve's balance sheet has ballooned to levels that will take years to work down. With low interest rates failing to drive an economic resurgence the Fed is looking to pump more money into the economy through purchase of treasuries (quantitative easing). The problem with all of these approaches is that they have been offset by a decline in the velocity of money. In good times the same dollar passed from one hand to another in the course of business activity. The faster this happens the greater the velocity. In good times one dollar could provide the benefit of five dollars as money passed through the economy. Now, with debt being paid down instead of funds being used for new purchases, corporations sitting on cash instead of increasing capital expenditures due to sluggish demand, and small to middle businesses reducing their borrowing because of similar lack of demand, money is piling up in corporations and banks. This results in the fulfillment of the Keynesian analogy of "pushing on a string."

How do we get out of this mess? It doesn't appear that pumping more money into the economy is going to work because there is enough money sitting idly by already. Unless and until we can find a way to increase the velocity of money we are going nowhere. And, in our humble opinion, this is the issue that policy makers should be attacking with creative, out of the box, thinking. It is crucial that we find the answers as failure could lead us to a Japanese type of economic malaise for an extended period of time. The more traditional remedy tried by the Japanese of lowering interest rates to 0% hasn't worked. Unless there is confidence that your financial ventures will not backfire because of a weak economy, you will not be inclined to assume the risk of investing or borrowing, even if the rates are low. And investors see unacceptable risk in this economy despite the opportunities.

So far we have learned that it is easier for the Fed's monetary policy and the government's fiscal policy to slow the economy than it is to jump-start it. For weeks there has been an expectation that the Fed was going to expand the availability of funds by buying treasury securities. If this doesn't generate the desired upswing in economic activity another bout of malaise is likely to arise. Eventually, not necessarily in the next 12 months, the attempts at stimulus will start to take hold but where will the markets, particularly real estate be at that time. Until then we see stock market volatility based on the psychology of the day, low interest rates creating an unattractive bond market, high unemployment and sluggish demand as the predominant environment. It seems strange to be making a statement such as this in the face of the declaration that the recession ended in June of 2009 but there aren't many followers of the economy that would necessarily agree with that conclusion. We hope we are wrong in our caution but have yet to see the broader strength that a recovering economy would offer. Until then maintaining diversification and having larger than normal reserves seems to be a reasonable option. The confidence necessary to increase the velocity of money and create a healthy economy may take some time to develop but we have faith that it will eventually come to fruition. Until that time we expect volatility to be the likely course for market action. If we could only pull on that string.

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DJIA (9/30/2010)	10,788.05
S&P 500(9/20/2010)	1141.20

