MV Capital Management Thought Content Series: Markets in Crisis

We're Here, What's Next?

December 10, 2008

Economy, Economy, Economy

On the evening of Election Day 2000, as candidates Al Gore and George W. Bush headed towards that inconclusive night and interminable recount battle, NBC's Tim Russert famously held up a little white board with "Florida, Florida, Florida" scrawled hastily in black magic marker, underscoring what that election ultimately boiled down to. Sadly Mr. Russert was not on hand to observe the proceedings eight years later, having died tragically of a heart attack in June of this year. It is fair to conjecture however that a Russert white board circa 2008 would have borne the phrase "Economy, Economy, Economy" in bold, definitive letters. This past election was all about the economy. Barack Obama's path to the Presidency was forged by the riveting currents of the onset of the worst economic downturn that most Americans have experienced in their adult working lives. And it is reasonable to opine that Barack Obama's future legacy as President starts with how he and the high-powered team he has assembled attack the many ill forces facing us today and help guide us back towards growth.

It's been a head-spinning several months, with the S&P 500 losing 33% between September 1 and November 30, basic lending markets frozen and a tidal wave of negative news about jobs, incomes, spending, home prices…practically anything that matters to most households. How did we get here? More importantly, how do we get out of this mess and what come next?

L'economie, qu'est-ce que c'est?

To begin, let us put some definitional context to answer the question: what is "the economy"? We hear the word bandied about by literally every talking head out there in the commentariat, but could we actually identify it? Pick it out in a crowd?

The US economy as of the end of the 3rd quarter of this year was worth about $14.4 trillion, as measured by GDP. GDP is a measure of all our collective output – the things we spend money on whether those "things" are interstate roads or recycling facilities or rhinestone-tipped Jimmy Choos.

We then divide that $14.4 trillion into its component parts. Consumer spending accounts for $10.2 trillion (that's where the Jimmy Choo purchases go). That's 71% of the total economy. Private sector investment accounts for another $2 trillion and government spending (including the giant defense budget) makes up $2.9 trillion. We import more than we export, so the "net exports" category subtracts $0.7 trillion from the total. Add these numbers together – personal consumption, private sector investment, government spending and net exports – and you get GDP. The economy, in other words.

So that's the thing we have to "fix" – that $14.4 trillion colossus we call our GDP. Moreover there's no particular mystery to the word "fix", which is simply interchangeable with "grow". If the colossus grows then we are on the right track. If the colossus shrinks then we are in trouble.

So if we know who the patient is and we know what the patient needs to do to recover, then why are the doctors so jittery as they pick up their surgical tools? We provided a hint to this answer a couple paragraphs above – *that's 71% of the total economy*. Consumer spending, that is. Apparently our economy lives and dies on the basis of how many Viking grills and gold-plated bathtub fixtures and dinners at Nobu we consume. The problem, as we all know, is that not only are consumers not in the mood to buy those souped-up Viking numbers that run into the thousands (or so we are told…) but they are reluctant to shell out $25 for a basic Weber model at the local Wal-Mart.

Quo vadis, consumer?

Consumer spending is in decline for fairly understandable reasons. Household incomes, the ultimate barometer of budgets for discretionary purchases, have been flat for a very long time and in the past couple years have decidedly trended negative in real terms. Meanwhile consumer debt has reached historic highs thanks to the tireless efforts of financial institutions to figure out new ways for people to spend money that they don't actually have. The asset side of most household balance sheets is dominated by housing values, and we all know how these have been doing. So these household balance sheets are short assets and long liabilities – not a happy confluence.

All these were facts well before September 2008 – but then came the credit crisis. The difference between August and October can be summed up thus: if you were someone with a good, though perhaps not stellar, credit score and you were *thinking* about buying a new car in August, by October your thoughts were far away from that as you *couldn't* finance the purchase with a new car loan even if you wanted to. The data points in for durable good sales (like cars and other major items that typically require financing) in October and November are dismal and presage a truly terrible 4th quarter GDP. This turn of events, of course, has also driven a stake through whatever remained of the flagging fortunes of US car makers, who are now in the intensive care unit while the Economy Doctors hastily rig up a temporary life support device for a $15 billion injection.

Then came the news last week that jobs disappeared in November buy the largest amount since 1974. Yep, the era of "Kung Fu Fighting" and regrettable wardrobe choices for the junior high class picture inexplicably continues to work its cloying influence on our present day *Zeitgeist*. But even that figure doesn't properly reflect the magnitude of problems in the US employment environment. Here's a sobering tale we came across the other week. It is a tale surprising in more ways than one – it marks the first time we have ever sourced a story idea for one of our commentaries from a Maureen Dowd op-ed piece in the *New York Times*. In her November 30 2008 column Dowd introduces *Pasadena Now*, an online newspaper whose founder pleasantly describes the newspaper business as a "one-way ticket to Bangalore [India]". All of *Pasadena Now's* content is developed and written by journalists in India (including Christmas tree-lighting ceremonies and other arcana local to the Pasadena scene), with the going rate being somewhere around $7.50 for every thousand words (that same thousand words would typically fetch between $200-800 when sourced locally).

The effects and the long-term implications of outsourcing could take up an entire discussion (and probably will resurface later on in this series of articles). But for now let's return the discussion back to consumer spending. So all these bad trends are depressing the consumer, and so in order to "fix" the economy we have to inject our growth serum into some other part of the body to kick-start the process. But where? Well, the phrase on everyone's lips these days is "government spending", for the simple if not entirely correct reason that it seems like something we can just decide to do. We can enact spending-oriented policies and – presto – the economy will grow.

Stimulus math

But the math gets tricky. Say, for example, that consumer spending declines by 2% (that would be somewhere on the rather tame side of current consensus expectations). That would imply a $200 billion decrease to total GDP, going back to our numbers earlier in this paper. So all else being equal (*ceteris paribus* for the Latin aficionados among us) all we would have to do would be to ramp up government spending by $200 billion to break even – right? And haven't we already done even more than that with all these bailout thingies that keep coming out every day?

Not really. We *did* in fact throw money at US consumers back in early 2008 – remember that? That was part of a government stimulus package to stimulate the economy including tax incentives for businesses and a grab-bag of other measures in addition to that $600 check that many of us received from the IRS this year. The government estimated the cost for the entire Economic Stimulus Act of 2008 to be $158 billion – not far from that $200 billion cited above but also clearly not enough to buttress the economy from the howling banshee of the credit meltdown that followed.

So then how much money is needed to fix the patient? Looking back, our whole perspective on money in the world of just two months ago seems rather quaint – remember the $700 billion stimulus package? That caused such a commotion back in late September, what with presidential campaigns being "suspended" and David Letterman blown off and Treasury Secretaries warning that failure to enact radical levels of spending within the next ten seconds would end the Holocene Epoch as we know it.

Of course other quaint little things – like daily swings in the Dow 500 points up or down – also managed to cause a stir back then but barely raise so much as an eyebrow now. Forget $700 billion – we're into mid-to-upper thirteen figures now. Economists look at our environment and see a landscape so bleak that otherworldly numbers are the only ones that even hold out some faint promise of hope. $5 trillion is not surreal or outlandish – it's just the ante.

The other thing that is not quite right in that example above is the assumption of *ceteris paribus*. An injection of $2 trillion or $5 trillion or whatever amount will certainly *not* result in a state of "all else being equal". Money injected into the economy through one channel will stimulate others – and now we come to the centerpiece of the Obama team's vision. Government spending – whether on infrastructure projects or new technologies or bailing out Detroit or Wall Street – should have a kick-start effect on both private business investment and consumer spending to a greater or lesser degree.

The recipe: is there a special sauce?

That "degree" really matters – and goes to the heart of what exactly the government decides to do. What's next? In simplistic terms, if all of the stimulus spending is applied to bailing out Wall Street firms, and if those firms in turn dole out most of it on seven and eight figure bonuses for their employees, then the "kick-start effect" of the stimulus will be pretty dismal indeed. Likewise if it all goes into helping auto and other industrial manufacturers avoid bankruptcy and go right back to their failed strategies of the past then our economy isn't going to get anywhere near that tipping point where stimulus turns into a self-fulfilling virtuous spiral of growth.

The problem with making choices like this is that none of them are glaringly obvious recipes for success. Investment in things that matter for the long term – education, public infrastructure, new healthcare or energy technologies – don't always produce great results in the short term. On the other hand focusing the solution solely on new ways to put more dollars into American hands to go out and use at the mall *today* may provide a short-term bump with nothing to show for it after a couple years (this in fact could serve as an apt characterization for that whole illusory mid-decade growth spurt from 2003-07, with empty Neiman Marcus shopping bags and vacant Miami condos as evidentiary proof). A successful plan has to contain a bit of both – something that stimulates more jobs, spending and investment in the short-term but has a real payoff – greater productivity, new industry sectors etc. – in the long run.

Moreover whatever the government spends will likely be much more productively applied if leveraged by private sector investment. The incoming Obama administration wants to achieve energy independence in ten years, and active investment in alternative energy could be a viable way to get there, while creating jobs and other primary and secondary stimuli along the way. Much more viable indeed this objective will be if Silicon Valley and other entrepreneurial hot spots around the country get into the act and attract sizable volumes of private capital formation via venture capital and small-business lending. If there is one thing the US arguably does better than anywhere else in the world, it is to nurture the entrepreneurial spirit and support the animal spirits of innovation and commercialization of promising new technologies.

A glass half-full

Will that be enough to slay the dragons of economic crisis that currently beset us? It is a narrow path through unfriendly terrain, but nonetheless it is a path. It's the best shot we have. The incoming administration should grab it with both hands and do whatever it takes to lead the way with aggressive, forward-thinking policies that upend the status quo, dispel the formidable resistance of the entrenched powers with a vested interest in the status quo, and communicate directly and honestly to grass-roots efforts in communities, businesses and other institutions about the inevitable sacrifices in the immediate term and the rewards in the longer term.

We have gone through wrenching changes before. The economy went into cardiac arrest in 1906-07 and again in the early 1930s. Both times we experienced profound change on many economic, political and cultural levels and emerged with new institutions – the Federal Reserve and anti-monopoly statutes in the early 1910s, labor unions, the progressive income tax system, the New Deal institutions and so on. We imagine that tangible new things will come out of this present period as well. And to be perfectly honest, we are more excited about the opportunities these new things may bring than we are despairing of the daunting obstacles that stand in our way. Call us Pollyannas, but that's how we see it. These interesting times – well, sometimes they are actually interesting in a good way.

With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

MVCM 2008 0024
DOFU: December 2008

MV Capital Management, Inc.
4520 East West Highway, Suite 400
Bethesda, MD 20814
www.mvfgroup.com
(301) 656-6545 tel
(301) 656-2722 fax