

MARTIN
CAPITAL MANAGEMENT, LLP
Regional Investment Advisors

FIRESIDE CHAT

Chat No. 4

April 2, 2009



This fourth Fireside Chat on April 2, 2009 continues a running economic commentary that began just over a year ago on March 3, 2008, as the bubbling financial crisis was about to boil over. The chat began on a cautionary note: “Make no mistake, I believe things are worse than they appear.” I went on to critically question commonly held beliefs. One that had achieved near universal acceptance at the time was that a repeat of something like the 1930s was impossible because of the many safeguards in place that did not exist 75 years ago. My rejoinder then was that such “conventional wisdom is as easily embraced as it is dangerously flawed. The defect is not so much in the efficacy of such systems but in how and why humans attempt to circumvent them.” The second belief was that the Fed was still in control of monetary policy, despite the domination of the financial innovators’ brainchild, the “shadow banking system.” The third was that cheaper money and the then just-enacted fiscal stimulus package would stem the tide of financial crisis and economic contraction.

The second chat on June 3, 2008 suggested several preconditions as necessary grounds for hope. “If

Congress can keep its legislative pen out of the inkwell and if the Fed can regain its lost composure, this will be the gloomiest of the Fireside Chats.” Nonetheless, it did not depart from the risk avoidance tone of the first chat: “This is one of those times that if you’re going to err, you are strongly encouraged to do so on the side of excessive caution. There is a time for heroes, but that time has not yet arrived.”

The third chat was conceived on November 5, the morning after Barack Obama was elected president by a 6% margin in the popular vote. Embodying the call for change, not unlike FDR in 1932 or Reagan to a lesser extent in 1980, whose margins of victory were 18% and 10%, respectively, Obama’s smaller but still substantial mandate was also rooted in economic woes, the worst since the 1930s. Roosevelt’s landslide victory in the depths of the Depression reflected a national cry for action. Hoover, who easily won the presidency in 1928 on the strength of the of prosperity and optimism in the late ’20s, was blindsided and then befuddled when the stock market crashed eight months after he took office. FDR’s first Fireside Chat, not unlike President Obama’s inaugural address before Congress,

focused on the enveloping financial crisis. Roosevelt ushered in a liberal, big-government era. Reagan faced a crisis of a different nature. Elected to bring an end to the stagflation of the 1970s, the time was ripe for his conservative ideology, which prevailed for almost 30 years. Consumed by the curse that success often breeds excess, the conservative era is ending ignominiously with the corruption of money. The third chat concluded with the rhetorical observation: “Whether a new Obama-led era of social and economic liberalism—if in fact that is how it will be remembered—ends with the corruption of power will be for our grandchildren to judge.”

In the meantime, a disturbing sidebar has emerged, known as inequality rage. While the problem is global, in the United States AIG is the largely misunderstood but convenient poster child. The battle lines between capital and labor are being drawn. Class warfare, vintage Karl Marx, is threatening to erupt.

Seventy days into the new regime, this fourth communiqué begins with a forced smile. Americans welcomed the Obama era in the same spirit in which the president-to-be had campaigned, betting on the triumph of hope over experience. But the harsh financial and economic realities are quickly gaining the upper hand as policy responses have continued the reactionary *ad hoc* pattern that characterized the waning months of the Bush administration, but with an increasingly leftist twist. The world’s stock

markets have been instant-messaging their escalating concerns, having shed roughly \$16 trillion in market value in the year leading up to the Lehman bankruptcy in mid-September of ‘08. In the six months following, the cumulative loss more than doubled to \$35 trillion, representing an overall 50% decline in value from the peak and an amount equal to a shocking two-thirds of the world’s GDP. Individual and institutional investors in the free and unfettered world’s equity markets voted with their feet, not to mention their computer’s mouse. Fear of financial failure and economic depression—along with bumbling and ineffectual means of slowing or stopping the snowball rolling inexorably downhill—sent investors in panicky pursuit of liquidity.

Unlike the first three chats, this one will focus on what’s behind the shocking headlines.

The March 24 prime-time presidential press conference provided further evidence that it takes more than raw brilliance and eloquence to restore confidence. Not knowing what to do is not the same as knowing what not to do. The interventionist policies that the president is advocating are, for the most part, at cross purposes with the free market’s blunt but inescapable cathartic process of rebalancing supply and demand. The world’s equity markets have served as a ruthlessly efficient laboratory for Economics 101. Accordingly, they will get to a clearing price long before the economy does. As Japan has borne full witness over the last 20 years, intervention-induced economic stagnation, a form

of torture by a thousand cuts, is worse by almost any measure.

The implicit assumption is that the collapse of the market value of capital assets is more acceptable than the physical and emotional human suffering that no economic depression is without. The owners of the world's businesses, it is reasoned by the non-capitalists, can afford it. That may be superficially so, but how confident can we be that the world's economy will naturally resuscitate itself, with the ratio of total debt to the market value of equities doubling, entirely because of the collapsing denominator? How much will the reverse wealth effect dampen consumption spending and the propensity for risk taking? A wet blanket has been thrown over the animal spirits and spontaneous optimism of free-market capitalism. The catalyst: the antisocial behavior of a comparatively few scoundrels who carried self-interest to system-threatening extremes. Now the question arises: Are we so blind to the lessons of history as to believe that managed-market capitalism will adequately fill the void?

Regarding the human cost of economic depression, could the choice be limited to two most unpleasant alternatives: short and steep or long and labored? As the capital markets have amply demonstrated, the excesses that insidiously invaded all sectors of the financial and economic system are not likely to be purged without consequences—of one kind or another.

The multi-trillion-dollar economic stimulus package just enacted is a politically expedient rejection of the free-market alternative. As was the case in the '30s, the call for a managed economy was based on the presumed failure of the market economy. However, the myriad financial bailout proposals are making it clear that the multitude of interdependent decisions that must be made simultaneously under ever-changing conditions more than boggles the mind. Central planners, no matter how much power they are granted or how bright they are, cannot hope to keep pace. For example, in proposing what he believes necessary to get the engine of recovery restarted, the president asserted in his press conference that it will be economic growth that will largely solve the future problem of burgeoning budget deficits. With government spending representing a third of GDP and rising, the assumptions about how effective it will be as an economic stimulant will play a huge role in determining the extent of the consequences years hence. Despite the president's assurances, at this point they are little more than hollow rhetoric. This is not a precise science.

The question nobody in Washington wants to address squarely in this warmed-over Keynesian stimulus package is: "What's the multiplier?" That is, for each dollar of government spending, how many dollars of GDP growth will result? Christina Romer, chair of the Council of Economic Advisors, states that the multiplier is about 1½, but the evidence supporting this assumption is flimsy at best. Normally the

multiplier is higher in recessions and depressions, but it is much lower for countries entering economic contractions already burdened with high levels of aggregate debt. If the multiplier proves to be well below 1, as well it could, it dramatically throws off all the projections about budget deficits, inflation implications, exchange-rate adjustments, etc. Errors in the assumptions about the economic multiplier could have the gravest of long-term consequences.

How could all this be happening? In the political/social/economic context, it appears the nation—and, increasingly, the world—are in the midst of a “perfect storm.” As noted in the 2008 annual report, action often takes precedence over measured thought—particularly in crisis. The quotation from Greek antiquity, “Nothing has more strength than dire necessity,” explains in part how the initiatives that encroach on individual liberties meet with so little resistance. The conservative cohort, the presumed protectors of liberty, has been so disgraced by rogue capitalists in recent years that the last man left standing is Rush Limbaugh. Could there be a sorer epitaph?

As the private sector surrenders more and more power to government, such a transfer is not without consequences. The public sector defaults into assuming the responsibilities that go hand in hand with the expanded authority. As the president outlined plans to manage the financial system, energy, healthcare, the auto industry, and education—to say nothing of spending trillions

attempting to stop the economic snowball—the logical response of the private sector, stripped of its authority, is to feel little or no responsibility for the outcomes. One is inclined to fret less about these critical issues because one is no longer saddled with personal accountability. The age of empowerment came and went so fast that we hardly knew it was here.

Think of it. Uncle Sam is about to do most of the heavy lifting. Lest we become too sanguine, though, let’s remember the admonition from Thomas Jefferson: The price of freedom is eternal vigilance, to which we might add, beginning with insistence on the rule of law. As the welfare system has made abundantly clear, government control breeds an attitude of entitlement. As more and more Americans are brought (*bought*) into the entitlement system, the more powerful become the forces to maintain it. Once the entitlement mentality reaches critical mass in a democracy, it becomes almost impossible to pass major reforms in reducing government intrusion. The public sector at all levels—federal, state, and local—is spending a third of GDP, and that share will go up now. The higher it is, the greater the number of people who are directly or indirectly dependent on the government’s largesse. The basic theory of interest-group politics is that such groups will use their influence to maintain their status. It may be important to recall that a government big enough to give you everything you want is also a government big enough to take everything you have.

In the distance a faint voice can be heard saying: “When the market economy is compared to the alternatives, nothing is better at raising productivity, reducing poverty, improving health, and integrating the people of the world.”

Moving from the abstract to the concrete, what do we make of the 23% levitation in stocks since March 9? In hyperkinetic markets, every rally begs the question: Is it the beginning of the next bull market, or is it a false positive? Short-sellers and trend-followers with itchy trigger fingers don’t want to be on the wrong side of a small move that becomes a large one.

As value investors, our perspective is more patient and measured, no doubt out of respect for the difference in the character of bull and bear markets. The big bull markets typically begin deep in the hole and then spend years climbing what market commentators have called a “wall of worry,” as memories of what created the hole in the first place slowly fade. The emotional forces motivating investor behavior are comparatively mild in generally rising markets, unless or until the bull phase reaches the stage where rising prices themselves become the primary exciting force propelling further advances. At that point prices effectively detach themselves from the traditional tethers to value. The detachment took place in technology stocks in the last half of the ’90s; most recently it manifested itself when housing prices advanced well beyond their historical growth trend line.

By contrast, grizzly bear markets are short, brutal, and, well, grisly. Fear of loss is among the most powerful of emotions and has no equal in bull markets. The thought of missing the train simply does not provoke the same level of response as sensing one is about to get run over by it. The more pernicious the bear market, the deeper and more disabling the emotional scars left in its wake. Fear of loss when loss is no longer to be feared is the disabling price paid by those who have been bear-clawed. MCM’s seemingly overcautious strategy from 2005 through 2007 reflected both our growing concern that things would not end well and our inability to predict if, when, and by how much. We thought it more important to be generally right than precisely wrong. Most of all, we worried that those who took risks for which they were undercompensated would one day refuse to take any risks, no matter how much they would be overcompensated.

We can’t call markets, but we can observe human behavior. We suspect that this secular bear market will end with a whimper and not a bang. Futile attempts to pinpoint some elusive bottom will eventually give way to despair. When buying bargains on the sale rack yields nothing but disappointment, when patience wears thin, and when hope is finally abandoned, opportunity clothed in black will be abundant. While nobody knows to what levels the popular indices might sink—and when—like the flipside of the bull market just passed, one need only be generally

right to sleep peacefully at night and earn low-risk, wealth-building rates of return.

The keynote to Franklin Roosevelt's inaugural address three quarters of a century ago serves well as the endnote for this chat: "This is preeminently the time to speak the truth, the whole truth, frankly and boldly. Nor need we shrink from honestly facing conditions in our country today. This great Nation will endure as it has endured, will revive and will prosper. So, first of all, let me assert my firm belief that the only thing we have to fear is fear itself—nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance. In every dark hour of our national life a leadership of frankness and vigor has met with that understanding and support of the people themselves which is essential to victory. I am convinced that you will again give that support to leadership in these critical days."

Until we chat again,
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