



April 2, 2009

Of the People, by the People, for the People

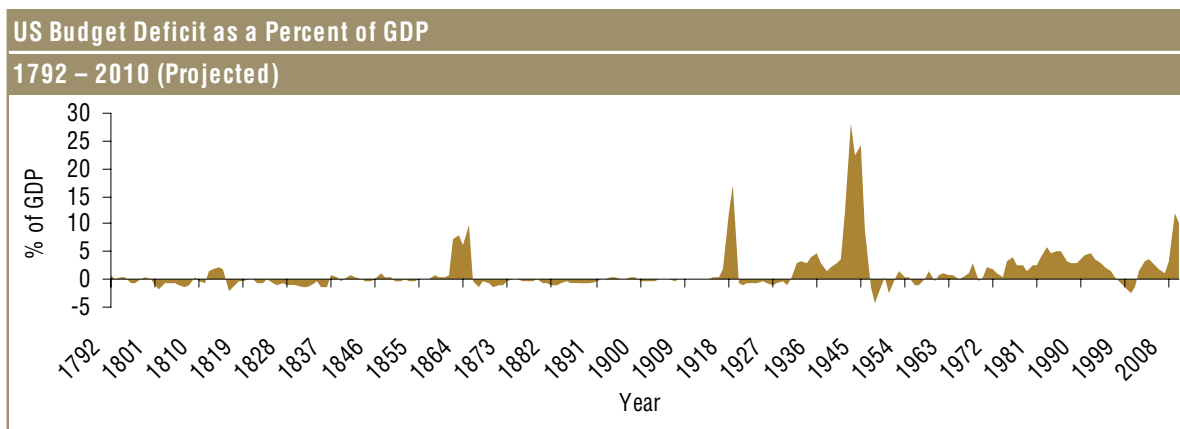
“There is nothing more permanent than a temporary government program.”

– Milton Friedman

Like it or not, a fundamental characteristic of life (and investing) in the United States over the intermediate future will be increasing levels of government involvement. The last twenty-five years (since Thatcher and Reagan) have been a period of mostly free markets, limited government intervention, and low levels of regulation. We are in the opening stages of a large experiment in government expansion into virtually every sector of the financial markets, and into many parts of the “real” economy as well.

Some recent examples:

- The Federal Reserve has committed to buying \$200 billion in Agency debentures, \$300 billion in Treasuries, and over \$1.25 trillion in mortgage-backed securities, thus becoming by far the largest participant in the mortgage market. This purchase commitment is equivalent to our expectation for all new mortgage issuance over the next two to three years.
- The Treasury has injected almost \$600 billion into banks and other financial institutions. In the case of Citigroup, the government is now the single largest shareholder in the second largest bank in the country.
- Beyond finance, the government has committed \$17.4 billion to prop up General Motors and Chrysler.
- As of the end of March, the Congressional Budget Office estimates that the 2009 fiscal deficit will be over \$1.7 trillion. That’s over 12% of GDP and represents the largest deficit as a percentage of GDP in 54 years. In fact, Federal budget deficits have exceeded 12% only twice in our nation’s history, the periods of World War I and World War II. The only other time deficits came close to his level was during the Civil War, as seen in the graph below.



Source: Datastream, usgovernmentsspending.com, and the Congressional Budget Office (CBO)

- Similarly, the CBO forecasts that 2009 government spending will increase to 24.9% as an overall share of the economy. This represents the biggest increase in the size of the federal government in the post-war era.

The Practical Guide to Sustained Government Intervention

- As Milton Friedman says, **temporary government programs have a habit of becoming permanent.** Wherever it intervenes, assume that the government will be involved for longer than you might expect.

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- **Government is very good at producing GDP.** Building roads, funding low-interest rate loans, subsidizing wind energy – all boost GDP. The government is not particularly efficient at, nor is it very good at, lowering the long-term rate of unemployment. We can also debate whether or not government “creates” GDP or merely “borrows” growth from the future, bringing it forward. But when it wants, government is good at increasing economic output.
- **The Fed wants homeowners to be able to refinance their mortgages at 4% or below.** Mortgage refinancing is perhaps the single most important transmission mechanism of easier monetary policy into consumers’ pockets. In addition to taking policy rates to near zero, the Fed is aggressively buying mortgage-backed securities to raise prices and lower mortgage interest rates. In his March 23, 2009 column in *The Wall Street Journal*, Treasury Secretary Geithner described how current policies were working to push mortgage rates down and refinancings up. As our own mortgage trader Jeff Nutt said recently about the direction of mortgage rates, “It’s mortgage supply versus the Fed, and the Fed is going to win.”
- **Be careful with historical comparisons.** Mean reversion and characterizations of “fair value” in financial markets are less meaningful in the presence of a large market participant (the government) that does not seek to maximize profits.
- **Policy mistakes are likely.** Quantitative easing by the Federal Reserve for longer than necessary may lead to inflation. Alternatively, government spending on unproductive projects may lead to overcapacity and deflation. The ex-ante outcome of a policy mistake is ambiguous, but the distribution of potential outcomes or “tail risk” is much wider than normal.
- We estimate that, through the end of 2008, six trillion dollars in new capital had already been committed in some fashion by the government. This is the equivalent of nearly 50% of GDP. Professor Ken Rogoff’s recent paper, “Banking Crisis: An Equal Opportunity Menace,” suggests that the average historical banking crisis costs 85% of a country’s GDP. **This implies the potential for another \$3 to \$4 trillion in US government cost before we’re done.**
- **Be skeptical of situations where prices are not determined by markets.** These could be due to poorly functioning markets, or to prices being set by non-market forces. Some recent examples and results: 1) Low-interest-rate financing of Thai real estate in the mid-nineties and the Thai Baht crash of 1997; 2) The Argentina Peso currency board with the US Dollar in the late nineties and the country’s ensuing sovereign debt default in 2001; and 3) Price caps on gasoline and multi-block-long lines at the pumps during the 1970s. These are all examples of crises exacerbated when prices were set by non-market forces.

Regardless of one’s belief in the efficacy or appropriateness of the current massive expansion in government, it is incumbent upon all of us as stewards of client assets to analyze as best we can the implications of this experiment. Government intervention is a social concept, a collective decision. It is not necessarily “good” or “bad.” The past twenty-five years have been a period of limited regulation, relatively small government, and the primacy of free markets. That period is over. An extended period of much greater government involvement is just beginning.

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