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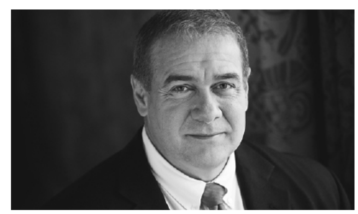
WEEKLY MARKET PERSPECTIVE

SEPTEMBER 1, 2010

ECONOMY

'Following the Mistakes of a Hero'

Comparisons to the 1930s Continued



BY SCOTT MINERD

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Western Pennsylvania offers its residents unparalleled natural beauty if little else. I know, because it's where I grew up. Unfortunately, in the shadows of the Appalachians lies a region that has been economically depressed for decades, if not centuries. It was there that my grandparents, the working-class children of German immigrants, lived on a small, seven-acre farm. They lost what little savings they had when the banks failed during the Great Depression, yet somehow they managed to survive on that resilient plot of land.

As a young boy I remember visiting my grandparents' modest home. They had a framed photograph of Franklin Delano Roosevelt proudly displayed in their living room, which is quite emblematic of the times I've been discussing in recent commentaries. Like my grandparents, many historians have immortalized Roosevelt as the savior of the common man. In truth, he was also the savior of the patrician class to which he was born, and possibly of capitalism as we know it.

Still, the hero that led the nation out of its darkest economic period most likely also led it straight into its second darkest hour – the recession of 1937 and 1938. Were it not for the Great Depression in 1929–1933, people would likely describe the Financial Panic of 2008 as the worst crisis "since 1938." Similar to the events of 1930s, today the U.S. economy emerges from one severe downturn only to face the fears of another on the horizon.

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'Comparisons to the 1930s'

The reason I've been discussing the 1930s at such great length the past several weeks is not for the sake of nostalgia. Rather, I would propose that we are living through a modern version of the Great Depression. The reason the economic disruptions have not been as dire this time around arises from the fact that policy responses have been significantly different. Nevertheless, the severity of the modern financial crisis and the breadth of its consequences are in many ways as far reaching and the policy reactions as revolutionary as those of the 1930s.

I believe one day we'll tell our children and grandchildren about the events of the "Great Recession." We'll recall the days of the Panic of 2008 just as my grandfather and father related the fabled stories of Appalachian life in the wake of the Great Crash of '29. Many will have stories similar to those told by my grandparents, who saw their life savings destroyed in a wave of bank collapses and watched as banks foreclosed on local business properties and their neighbors' homes. Just as jobs were precious and few for them, so they are today for many Americans. Similarly, just as Americans pinned their hopes on a new Democratic administration led by a charismatic leader's ideals of societal reformation through a series of unprecedented programs and expansions of federal powers, so a modern generation facing a systematic collapse of asset prices and financial institutions has pinned their hopes on another charismatic leader promising "hope" and "change."

The parallels of these two ages are both instructive and sobering. As I've often quoted Mark Twain as saying, "History doesn't repeat itself, but it does rhyme." By evaluating the successes and failures of the 1930s, investors can not only illuminate the events of the Great Recession for the sake of perspective, but also gain further insight into the ramifications of current monetary and fiscal policy decisions on the future of markets and investments. With this in mind, I hope you will find utility in this week's commentary on the 1930s, as we seek to gain insights into the policies that we hope will guide the economy safely through the present crisis.

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'Exit Depression, Enter FDR'

Many people don't realize this, but Herbert Hoover actually presided over the entire Great Depression. Roosevelt took office in March of 1933, the exact month the National Bureau of Economic Research says the 43-month-long

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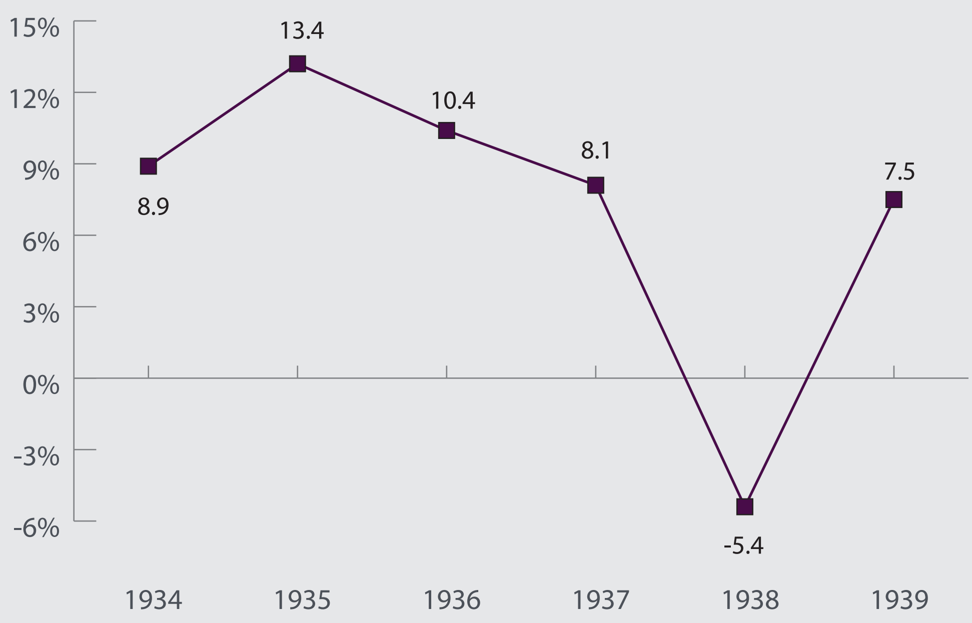
recession officially ended. Nevertheless, Roosevelt inherited a panicked nation in turmoil where one in four Americans was unemployed. As difficult as the first few years were, by the numbers Roosevelt's first term was characterized by robust recovery in the equity markets, the job market, and the economy as a whole. As I've noted before, from 1933 to 1937, GNP grew at an annualized rate of 10 percent, the Dow rose approximately 20 percent per annum, and unemployment declined from as high as 25 percent in 1933 to as low as 11 percent in 1937.

The robustness of the recovery from 1933 to 1937 is generally forgotten due to the severity of the second recession in the 1930s, which hit suddenly in May of 1937 and continued until March of 1938. During this brief period, national output declined by 5.4 percent, unemployment skyrocketed from 11 percent back to 20 percent, the Dow Jones Industrial Average declined 49 percent, and four years of healthy price recovery receded into 3 percent annual deflation.

'AN ABRUPT SHOCK TO THE SYSTEM' – THE RECESSION OF 1937-1938

The robustness of the economic recovery following the Great Depression is generally forgotten due to the severity of the second recession in the 1930s, which hit suddenly in May of 1937 and continued until March of 1938. During this brief period, national output declined by 5.4 percent.

Real Gross National Product (GNP): 1934 to 1939



Source: Federal Reserve of Minneapolis

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What derailed the recovery of 1933 to 1937? The short answer is that it was a confluence of factors, a perfect storm of monetary and fiscal policy mistakes. Last week I discussed many of the monetary policy missteps the Federal Reserve made during the 1929-1933 Depression. Chairman Bernanke characterized the Fed's actions in 1937-1938 as similarly "misguided" and "unnecessarily tight."

As a student of the Great Depression, I believe Chairman Bernanke is well aware of the Fed's mistakes during this period and has already proven that "tight" is not an adjective he wants associated with monetary policy today. The more pertinent lessons come from the fiscal policy missteps of the Roosevelt Administration, who, in an effort to balance the budget after six years of deficits, implemented a series of tax increases in 1936 and 1937 that caused output, prices, and income to fall and sent unemployment skyrocketing.

"What derailed the recovery of 1933 to 1937? The short answer is that it was a confluence of factors, a perfect storm of monetary and fiscal policy mistakes."

'The Promise of the Balanced Budget'

To understand the fiscal changes enacted in 1936 and 1937 by the Roosevelt Administration, one must first understand the presidential election of 1932. As has been established, 1932 was a dark time for the U.S. economy. From the onset of the Depression in August of 1929 to the election of 1932, it's estimated that real GNP (the standard measure for total economic output of the time) declined 29 percent, consumer prices fell 27 percent, and the Dow Jones Industrial Average plummeted approximately 85 percent.

Although the incumbent Herbert Hoover worked diligently to balance the budget – succeeding in nearly three of his four years in office – by 1932 it was apparent that increased government spending would be required. Aggregate demand in the economy had fallen some 30 percent as a result of the restrictive monetary policy of the Federal Reserve and a massive spiral of debt deflation (i.e., successive declines in asset values sparking foreclosures and loan losses that in turn fuel further declines in asset values). The central question of the presidential election in 1932 was who would be the man to lead government intervention. From the time when Hoover took office to when he stood for re-election, over 13 million Americans had lost their jobs. Needless to say, popular opinion in 1932 held little faith that Hoover would be able to lead the nation out of darkness and into the light.

It was during the bleak days of 1932 that the Democratic Party built a campaign around the themes of "hope" and "change" (it sounds eerily familiar, but I am not making this up).

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In addition to the fears and horrors rampant in the economy and society at large, there was another "evil" to be credited to the incumbent Hoover Administration – the fact that it ran a deficit of approximately 3 percent of GNP in 1933. In response to this, if elected, the Democratic Party platform solemnly promised to balance the budget. In fact, in one section of a published manifesto, dated June 27, 1932[1], the Democratic Party stated that it "solemnly promises by appropriate action" to implement a "drastic reduction of governmental expenditures...accomplishing a saving of not less than 25 percent in the cost of the Federal Government." It further advocated "the maintenance of the national credit by a federal budget annually balanced."

"By the 1936 election, Roosevelt fell under heavy criticism for vehemently endorsing a balanced budget in the 1932 election and then running four years of deficits while in office."

Roosevelt easily defeated Hoover in the fall election of 1932, and the Democrats took Congress as well. The reason I stress the "solemn promises" to balance the budget in 1932 is because these promises would come back to haunt the Democratic Party in the election of 1936. In the meantime, during his first term, Roosevelt implemented expansionary fiscal policies that led to the largest peacetime budget deficits up to that time. By the 1936 election, Roosevelt fell under heavy criticism for vehemently endorsing a balanced budget in the 1932 election and then running four years of deficits while in office.

In response to such Republican criticism of his fiscal policies, Roosevelt fired back by issuing the following points in the Democratic Party platform of 1936 (my paraphrase, followed by direct excerpts originally published June 23, 1936[2]):

1. *Deficit spending was a result of the crisis inherited from the previous Administration:* "We hold this truth to be self-evident – that 12 years of Republican leadership left our Nation sorely stricken in body, mind, and spirit; and that three years of Democratic leadership have put it back on the road to restored health and prosperity."

2. *The Democratic Party restored confidence in America, thus the cost of deficit borrowing had declined to extremely low levels:* "We have raised the public credit to a position of unsurpassed security. The interest rate on government bonds has been reduced to the lowest level in 28 years."

3. *The Democratic Party would still balance the budget through the austerity of limited growth in government and by higher taxes:* "We are determined to reduce the expenses of government...Our retrenchment, tax, and recovery programs thus reflect our firm determination to achieve a balanced budget and the reduction of the national debt at the earliest possible moment."

Footnotes 1, 2: see transcripts of Democratic Party platforms at www.presidency.ucsb.edu/platforms.php

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'HIGHLY CORRELATED' – DECREASES TO THE BUDGET DEFICIT AND INCREASES IN UNEMPLOYMENT

In May of 1937, the national unemployment rate was 11.2 percent, the lowest level since the beginning of the Depression. Over the course of the next year, as the government worked aggressively to balance the budget and monetary policy remained tight, unemployment would soar back up to 20 percent.

Changes in the Budget Deficit vs. Changes in Unemployment: 1935 to 1939

Source: BCA Research, Guggenheim Partners, LLC

'Re-election and the Slide Back into Recession'

As a result of the political confrontations of the 1936 presidential election – and in reaction to a pervasive, mythological belief that a balanced budget was somehow necessary and good for the economy – Roosevelt signed into law a series of tax hikes that included increases in personal income taxes, corporate income taxes, excise taxes on dividends, corporate "excess profits" taxes, liquor taxes, real estate taxes, and the very first Social Security payroll tax of 2 percent.

For the sake of context, in 1931, the highest marginal personal income tax rate was 25 percent. In 1932, in the midst of dramatically declining revenues and rising government costs associated with the Depression, Herbert Hoover raised the rate from 25 percent to 63 percent. In 1936, against a backdrop of economic recovery and gains in employment, Roosevelt raised the highest marginal income tax rate yet again, this time from 63 percent to a punitive 79 percent.

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Roosevelt would also raise taxes on corporate retained earnings. Coincidentally, as I was writing this week's commentary, I saw an article in The Wall Street Journal by economists Lee Ohanian and Thomas Cooley titled "FDR and the Lessons of the Depression." Specifically, the article cites tax increases and wage increases (resulting from pro-union government policies) as primary contributors to the economic slide of 1937-1938. According to Ohanian and Cooley, Roosevelt's 1936 sliding-scale tax on retained earnings taxed any corporate profits not distributed to shareholders. The tax, which could equal as much as 27 percent of net income, "significantly raised the cost of investment" for businesses. In addition, the tax rate on dividends in 1936 was raised to more than double the rate of 1932. Ohanian and Cooley also cited research conducted by Ellen McGratten of the Federal Reserve Bank of Minneapolis. She proposes that the Roosevelt Administration's capital income tax policy, in particular, was the cause for much of the 26 percent decline in business fixed investment that occurred in 1937-1938.

"Someone once asked me what Roosevelt did that was so bad leading up to the recession of 1937-38. The answer I give is simple: 'He attempted to balance the budget at the wrong time.'"

'1937-1938: What Went Wrong'

Someone once asked me what Roosevelt did that was so bad leading up to the recession of 1937-38. The answer I give is simple: "He attempted to balance the budget at the wrong time." More specifically, he attempted to balance the budget by increasing tax revenues at a time when the economy was still finding its footing and the Federal Reserve was attempting to reverse policy. Even after the four years of recovery following the Great Depression, when Roosevelt began his series of tax increases unemployment remained over 12 percent, which on its own would be considered the worst labor market in modern U.S. economic history.

If the Roosevelt Administration's driving purpose was to prove to the world that it could balance the budget, it was successful. In 1937, the budget deficit declined by 1.9 percentage points in relation to GNP. In 1938, that trend continued with the deficit declining another 1.4 percentage points in relation to GNP. By December of 1938 the Roosevelt Administration had essentially achieved its goal of a balanced budget.

But what was the cost of such actions? According to data from BCA Research, the unemployment rate went from 11.2 percent in May of 1937 to 20.0 percent just 14 months later. Data from the Federal Reserve Bank of Minneapolis shows the overall economy contracted 5.4 percent in 1938. The Dow Jones Industrial Average fell 49 percent from March 1937 to March 1938. Two years later, in

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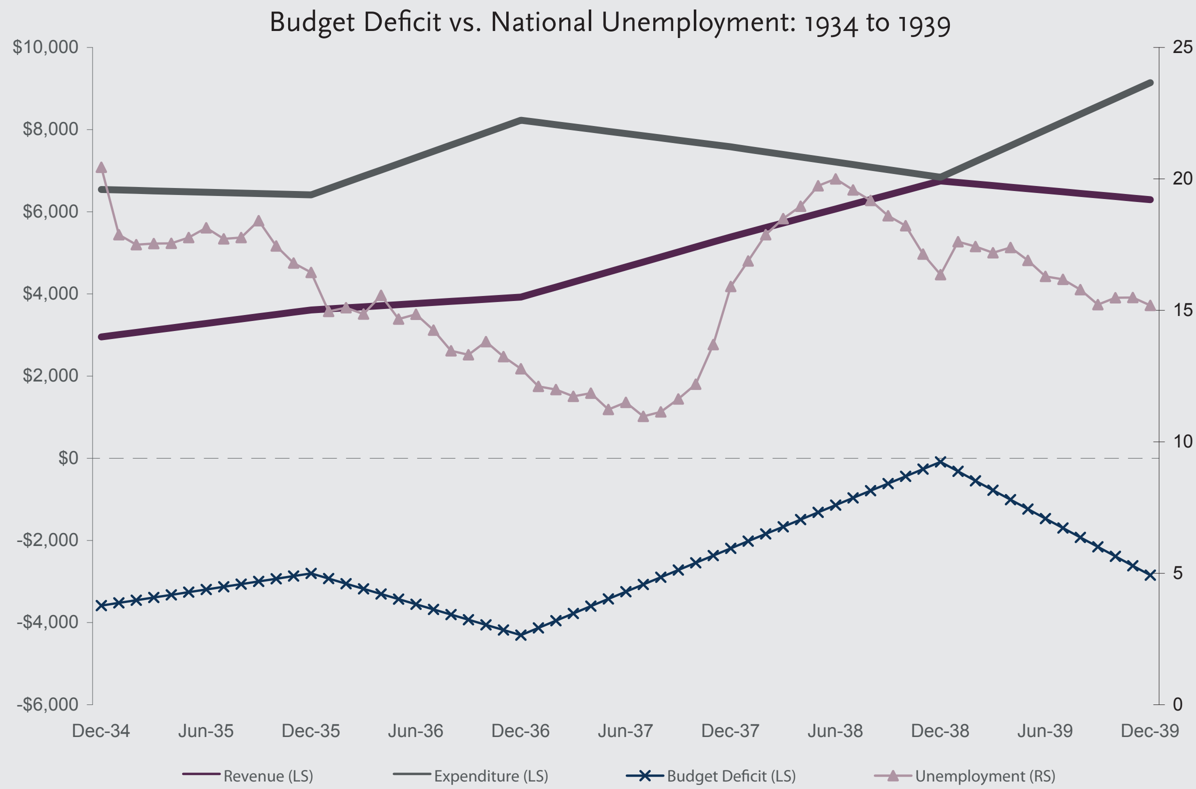
'BALANCING THE BUDGET AT WHAT COST?' – FISCAL AUSTERITY HELPED CAUSE THE 1937 RECESSION

For one month in 1938 the budget deficit was reduced to just $89 billion dollars – nearly, but not quite balanced. The cost of such actions was the recession of 1937-1938, when unemployment skyrocketed from 11 percent to 20 percent in 14 months, GNP fell 5.4 percent, and the Dow Jones Industrial Average declined 49 percent.



Source: BCA Research

March of 1939, the equity market remained depressed, still 30 percent below its March 1937 levels. The U.S. economy, which had whipped unemployment down from 25 percent in 1933 to 11 percent in 1937, limped into the 1940s with unemployment hovering just over 15 percent. The silver lining of all this economic carnage? For one month in 1938 the budget deficit was reduced to just $89 billion dollars – nearly, but not quite balanced.

'Left in the Lurch'

It's evident from Chairman Ben Bernanke's speech in Jackson Hole last week that the Fed stands ready to continue to provide quantitative easing if necessary. I believe it will be necessary since the economic data in the next few months is likely to be pretty ugly and the rhetoric out of Washington is likely to devolve into a nightly news highlight reel of partisan feuding.

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Yet despite the Fed's commitments, some of the same issues that occurred in 1937 loom on the horizon today. For instance, in the first quarter of 2011 the United States faces massive tax increases. Similar to the mid-1930s, many have argued that deficits must be tamed now and that the economy is healthy enough to sustain austerity measures. Under such political pressure, it appears unlikely that even a portion of the Bush tax cuts will be extended.

There are a host of economic forecasts about the potential size of the fiscal drag that would result from a full expiration of the Bush tax cuts. Macroeconomic Advisors, for instance, believes it will subtract 0.9 percentage points off GDP. ISI Consulting thinks it could be even larger, around 1.2 percentage points. Arthur Laffer, the famed supply-side economist, prefers a number significantly larger, predicting as much as 6 percentage points of fiscal drag. Any way you slice it, if estimates for economic growth in 2011 range from 2 to 3 percent, these tax increases could result in flat to anemic growth and elevate the risk of recession due to the slightest bit of economic turbulence.

In addition to the expiration of the Bush tax cuts, there is the additional cost of healthcare reform. While some would argue that healthcare reform is just a transfer payment program, the fact remains that there will be no incremental healthcare benefits available in the next three years. Therefore, the transfer payments, which are intended to be revenue neutral over the next 10 years, actually create a fiscal drag between 2011 and 2013 before becoming modestly stimulative when the benefits become available from 2014 to 2020.

The good news is that even if policymakers proceed with the aforementioned tax increases at least one thing is certain – Bernanke is clearly a student of the Depression. He recognizes both the monetary and fiscal policy blunders of 1936 and 1937. In his speech at Jackson Hole, Bernanke admitted that "managing fiscal deficits and debt is a daunting challenge for many countries." Then, in the next breath, he made the point that nevertheless "a return to strong and stable economic growth will require appropriate and effective responses from economic policymakers across a wide spectrum...central bankers alone cannot solve the world's economic problems."

Essentially, I believe Bernanke's telling Congress not to leave the Fed in the lurch. He reinforced this message, saying: "Incoming data on the labor market have remained disappointing. Private-sector employment has grown only sluggishly... Firms are reluctant to add permanent employees, citing slow growth of sales and elevated economic and regulatory uncertainty." The "regulatory uncertainty"

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comment could be perceived as a subtle shot across the bow of the Obama Administration, or at least a plea for help from the policymakers in Washington.

'Effects on the Markets'

One clear consequence of the repeal of the Bush tax cuts will be an urgency to accelerate taxable income into 2010. This will have a number of impacts on the market, the most direct being a desire to liquidate positions in equities and other financial assets to realize capital gains before the New Year. This will continue to put downward pressure on equities and increase volatility.

Last week, Bernanke also referenced the importance of a "baton pass" from the economic boosts of government spending and inventory replenishing to the more sustainable support of consumer spending. If equity prices decline in conjunction with the renewed pressure on the housing market as tax incentives are removed, the net effect is likely to be an adverse impact to already fragile consumer sentiment and spending. In essence, the economy is in danger of a fumbled baton pass from 2010 to 2011.

In the face of this uncertainty, and in light of the Jackson Hole remarks, it appears Chairman Bernanke and the FOMC will find it necessary to increase their holdings in long-term securities and increase the size of their balance sheet. This will ultimately lead to lower interest rates and a need to maintain low long-term rates for several years in a hope to prop up the housing market by maintaining record low mortgage rates (see my recent commentary on "The Story in Housing").

What remains to be seen is how severe the economic headwinds will be as a result of the fiscal tightening going into 2011, and how dramatically the Fed will move once it reaches the decision to continue to grow its balance sheet. In the short run, given the amount of purchases that the Fed will have to make, quantitative easing will most likely swamp the amount of incremental borrowing required by the government, which means that financing the deficit won't be a problem. Ultimately, however, the U.S. economy will come to the end of the road and inflation concerns will reemerge.

Historically, deflationary or disinflationary pressures tend to reach their peak about two and a half years after the end of a recession. For example, the "deflation scare of 2003" occurred in June of that year, approximately two and a half years after the recession that ended in November 2001. The recession of 1990-1991, which ended in March of 1991, saw interest rates trough in October

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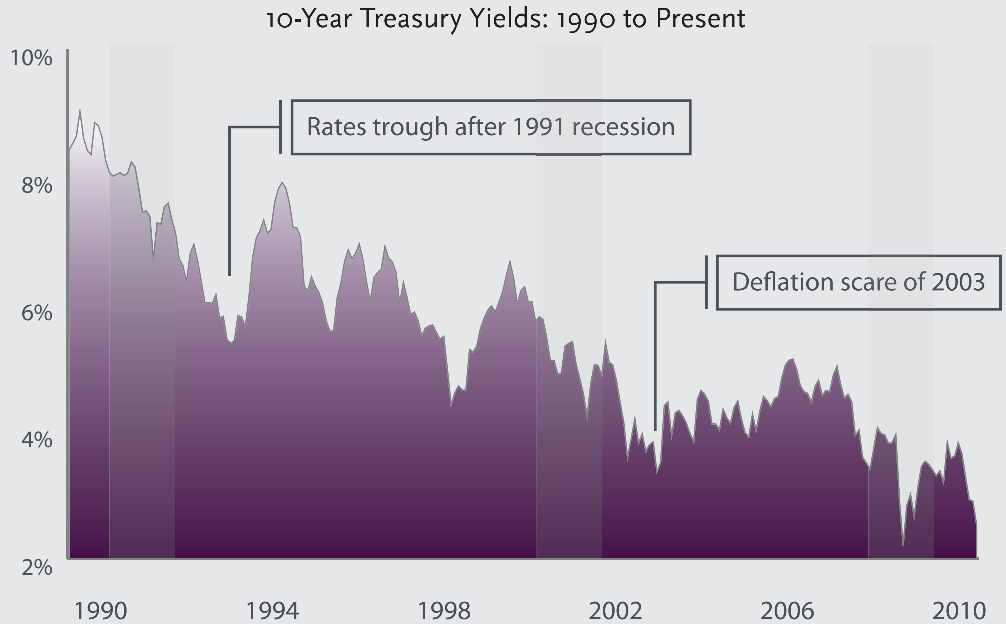
'EVIDENCE OF DEFLATION FEARS' – 10-YEAR TREASURY YIELDS 1990 TO PRESENT

Historically, deflationary or disinflationary pressures tend to reach their peak about two and a half years after the end of a recession. Evidence of deflation fears or disinflationary pressures reaching a peak can be found in the troughs of 10-Year Treasury yields following recessions.



Source: Bloomberg

of 1993, approximately two and a half years later as well. Looking at the average of the recessions in 1970, 1975, 1982, 1991, and 2001, long-term interest rates began to rise approximately 29 months (two years and five months) after the end of a recession. If this historical pattern holds true, the window for interest rates to trough today would be somewhere between here and the fourth quarter of 2011 or the first quarter of 2012. That would most likely be the time when there is more certainty around the economy and attention will be turned to inflation. This could be extended beyond the traditional period of two to two and a half years due to the severity of many factors associated with the Financial Panic of 2008. But if the Fed does what I believe they will do – i.e., rev up quantitative easing – in all likelihood rates will trough somewhere between late 2011 and early 2012.

The near-term silver lining is that at least the uncertainty plaguing the market today will be resolved sooner rather than later. Either the Fed's next round of quantitative easing will begin to revive the economy, or the Obama

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Administration and a potentially Republican Congress will find some form of Keynesian stimulus to put to work (possibly even a supply-side remedy such as a payroll tax holiday!). The timing on these answers should be clear before the fourth quarter of this year or the first quarter of 2011.

The economy is waiting for quantitative easing to see if it will be able to reverse the economic slide and, most importantly, put Americans back to work. If it doesn't, the newly elected Congress will have its hand forced to increase deficit spending and take action somehow. Either way, the result is that long-term interest rates will go lower in the near term before eventually rising.

'And Then Things Get Interesting…'

I believe further quantitative easing is likely to take place in the near term. I also believe there is a strong probability that there will be some form of additional fiscal stimulus passed by the government as it yields to mounting pressure to address the nation's historically high unemployment rate. After these two events take place, the stage should be set for the green shoots of recovery to reappear in 2011. Once these harbingers of economic health appear, the Fed will come under pressure to convince the market that it has a sound exit strategy to unwind its massive balance sheet. Simultaneously, pressure will reemerge for fiscal austerity and deficit reduction.

As we approach the presidential election of 2012, monetary and fiscal policymakers will be faced with their greatest challenge: whether to reverse the emergency policies applied up to that point, and if so, at what pace and timing to conduct such measures. The risks surrounding these decisions are even greater than the risks that surround the near-term policy decisions about further fiscal stimulus and quantitative easing – taking away support is always more difficult than giving it. The dangers will be strikingly similar to the risks that faced the economy in 1936. Remember, it was Roosevelt's dash to fiscal discipline in 1936 – combined with the Fed's misguided decision to tighten monetary policy by doubling the required reserve ratio for banks – that resulted in the severe fiscal drag on aggregate demand and economic output that pulled the economy back into a deep recession.

While I remain optimistic that the current economic "soft patch" will not unravel into a full-blown recession, my concern increases when I look ahead to the challenges the economy will face once it regains its footing. The parallels to 1936 grow increasingly striking the closer one looks to 2012, especially if the

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green shoots of economic recovery take hold between now and then, which I believe they will thanks to additional policy actions later this year and in early 2011. Oddly enough, the foundation for the recession of 1937-1938 was laid in the election year of 1936. The question remains, will the presidential election of 2012 lay the foundation for a parallel series of events? Given the unprecedented monetary and fiscal policies enacted in recent months, as well as those that are likely to be enacted in the near term, the opportunities for future errors of policy judgment loom large. In light of this, whether it's in relation to 2010 or 2012, the lessons of 1936 are stark and disturbing.

'What this Means for Investments'

As for now, where do I believe opportunities exist for investors? In September and October, it appears that rates will continue to fall, either as a result of further quantitative easing or continued economic disappointments that will cause the markets to price for the worst-case scenario. The 10-year Treasury note will likely remain a buying opportunity, with an eye to exit as yields fall to 2 percent or even lower, which should be before the end of the year. During this same period, equities are likely to remain under pressure, and volatility is likely to rise. With equities currently fundamentally "cheap," how can investors time the entry point? Just as it was in 2009, equities are likely to stabilize and rise in value once a new program of quantitative easing begins. Therefore, quantitative easing is most likely the appropriate "buy" signal. Outside of equities, monetary substitutes such as precious metals, art, and other collectibles will continue to benefit from economic turbulence as well as further quantitative easing. Industrial metals such as copper, lead, and nickel are also likely to benefit from future monetary and fiscal stimulus in 2011.