INVESTMENT UPDATE NEWSLETTER

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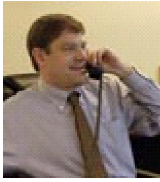

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Federal Surrogacy and the Pace of Pain

The phrase *"worst since the Great Depression"* seemed to qualify every financial news story last fall and winter, but now it must give way to the unaccustomed words "*best* since the Great Depression." At least so far as U.S. stock market rallies are concerned. Indeed, the Dow's five month spurt through last week beat any since 1938, and resembles as well the snap-back rally following the Crash of 1929. It not only noses past formidable contenders such as the 40%+ NASDAQ run in 2002, but also recalls rallies far from these shores, such as six runs of 45% or better by Japanese stocks after their 1989 peak (thank you, Dr. Marc Faber).

Whatever their differences – a few percentage points or a dozen time zones here or there – these stunners had one thing in common: not enduring.

Will 2009's happy fest continue? The Federal government as embodied by the Fed, Treasury, Congress and White House, seems determined to provide an environment that will encourage it to do so, even if this begets a new conundrum: So long as the government keeps its foot on the gas, pedal-to-the-metal (as we used to say when cars were more steel than plastic), equities have reason to rise – if not quite a robust rationale – yet also more and more to be fearful of, as the Federal behemoth crowds into industries in ways alien to recent American experience.

We're in a moment not so much of big government (a term which suggests permanence and mass) as of ubiquitous government spread thin. Federal surrogacy is everywhere, trying to take the place of market factors where private players either don't want to play their part anymore or just plain can't. This is not a partisan issue – we've seen it across a Republican and now a Democratic administration – whether in the *de facto* Federal absorption of AIG, Fannie Mae and Freddie Mac on Bush's watch, or in Obama's mopping up of the automakers, ongoing Federal backstops for corporate and municipal obligations, and gimmickry such as the much heralded Cash for Clunkers program, which is less a revelation of economic strength than it is a confirmation of what any kindergartner could have told us: when offered money, people take it.

Let me highlight an observation by David Rosenberg, Chief Economist at Gluskin Sheff:

"Year-to-date, total personal disposable income has risen at a 10.8% annual rate due to Uncle Sam's generosity; however, wages and salaries (60% of the income pie) have declined at a record 3.1%."

A dollar of income growth from Federal freebies does NOT equal a dollar derived from productivity-based earned income. Whereas the latter constitutes the very sinew of prosperity, the former is really a liability exercise that pulls wealth from future tax revenues or debt monetization, just as surely as Cash for Clunkers pulls demand from the future and dampens future car sales.

All of this slows our pace down the path to a necessary realization: that as a nation in the midst of relentless private sector deleveraging, we aren't as rich as we thought, just more in hock than we ever appreciated. The government wants to delay this reckoning and so spare us the attendant pain, even if that means the government itself must go deeper in hock to do so.

As for the stock market's whooping in July, Wall Street lowered the hurdle bar of its own (and investors') expectations, set it gingerly on the ground, then moved aside and cheered as the second quarter's earnings reports stepped over it. While three-quarters of companies have beat downwardly revised bottom line expectations (Standard & Poor), anecdotally at least they've been disappointing on revenues, and just a quarter of companies report growing their top lines so far (Zacks Investment Research). This suggests not recovery, but retrenchment.

Until top lines (revenues) show signs of improving without government intervention, we'll keep our defensive posture. Thus, our own pace of pain: We prefer to suffer now by partly passing up what we believe to be unsustainable stock valuations given the fundamentals. Sometimes, relative returns must suffer in the short-run if absolute returns are to endure for the long run.

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