



Investment Perspective

“Nothing is so permanent as a temporary government program. If you put the government in charge of the Sahara Desert, in five years there’d be a shortage of sand.” – Milton Friedman

As we recently celebrated our nation’s independence and freedom, we thought it appropriate to begin with a quote from the staunch advocate of free market capitalism, Milton Friedman, who also once said “Underlying most arguments against the free market is the lack of belief in freedom itself.” Markets are now “free”, for the first time since late 2008, from intervention (aka “QE”) by the U.S. Federal Reserve, which ended its latest round of QE June 30. Well, sort of. The Fed plans to continue to reinvest proceeds from maturing securities, thus maintaining the size of its balance sheet at a record \$2.9 trillion. In a nutshell, this means the Fed believes the economy is doing better, but that it is not quite healthy enough to grow and create jobs on its own. Translation: continued government intervention.

The Bank of Japan is much less subtle with its intervention, announcing in March it would use 900 billion yen to buy stocks in the Japanese stock market. Several astute traders noted the purchases take place when the Japanese stock market drops 1%, thus the Japanese central bank has effectively placed a floor under stocks. Hilariously, Governor Masaaki Shirakawa of the Bank of Japan warned on March 9 in a lecture in Germany “there is an increasing possibility that central banks will no longer be seen as neutral institutions, partly due to their stronger intervention in resource and capital allocation at the micro level.” You think?

The purpose of the U.S. Fed’s unprecedented level of intervention, it seems, was to keep interest rates low to stimulate the housing market and loan demand, boost asset prices and thus confidence through the wealth effect, and increase inflation *expectations*. Well, how did they do? Stocks are up significantly since the start of QE, and inflation *expectations* (and actual inflation) have increased significantly, yet low rates have failed to stimulate any real demand for loans or housing. So, it seems the Fed was at least partially successful. Unfortunately, this modest success hasn’t translated to any meaningful economic improvement to most Americans. Bleak consumer confidence readings and a slight uptick in unemployment illustrate the degree to which the average American remains fairly miserable. Indeed, the “Misery Index”, which combines inflation with unemployment (created in the 70s as a method of tracking stagflation), recently hit its highest level in 28 years.

Despite the recent grim economic data, investors bid up stocks at the end of the quarter, thus erasing a large chunk of the correction that began in early May. Investors eager to latch on to the notion that the economy encountered a temporary “soft patch” in Q1 noted Japanese industrial production bounced back sharply in April and that oil pulled back almost 17% from its recent highs. Still, the stock market’s recent rebound would be a lot more believable and confidence-inspiring were it accompanied by more credible evidence that the economy was poised to recover from its sharp slowdown in Q1, yet such evidence remains scarce.

Recent government intervention notwithstanding, our markets remain (mostly) free and our economy has the fundamental strength to recover. The de-leveraging process that began in 2008 will take many years to play out and will likely mean slower growth than we are used to, and therefore the recovery in jobs will take longer. Slower growth and lack of credit expansion probably means asset values will remain restrained, likely making markets more susceptible to shock and volatility as the last vestiges of the credit bubble are wrung out. As always, maintaining a well diversified, balanced portfolio is the best defense against the uncertainty wrought by market volatility, unpredictable government intervention, and unforeseen natural disasters or geopolitical issues.

July 2011