2011 1st Quarter Stock Market Commentary

CHAINSAW BEN

Blessed are the young, for they will inherit the national debt.
- Herbert Hoover

In early 2008, Stephen J. Dubner and Steven D. Leavitt (co-authors of *Freakonomics*) published an opinion piece in the New York Times which discussed situations in which policies lead to outcomes diametrically opposite to what was intended. They cited the case of a prospective patient who was experiencing knee pain and called the office of Dr. Andrew Brooks, a highly regarded orthopedic surgeon in Los Angeles. The patient also was deaf. She wanted to know if her deafness posed any problem for the doctor. He indicated that this posed no special problem since he could easily discuss her situation using knee models, anatomical charts and written notes.

The woman later called again to say she would rather have a sign-language interpreter. The doctor agreed and asked his assistant to make the arrangements. To his surprise, he found that an interpreter would cost $120 an hour, with a two-hour minimum, and the expense wasn't covered by insurance. Brooks didn't think it made sense for him to pay. That would mean laying out $240 to conduct an exam for which the woman's insurance company would reimburse him $58 – an out-of-pocket loss of more than $180, before accounting for taxes and overhead.

So Brooks suggested to the patient that they make do without the interpreter. That's when she told him that the Americans With Disabilities Act (A.D.A.) allowed a patient to choose the mode of interpretation, at the physician's expense. Being skeptical, Brooks researched the law and found that he was obligated to do as the patient asked unless he was willing to risk a lawsuit.

He went ahead and examined the woman, paying the interpreter out of his pocket. As it turned out, she didn't need surgery; her knee could be treated through physical therapy.

Brooks told several colleagues and doctor friends about his deaf patient. "They all said, 'If I ever get a call from someone like that, I'll never see her,' " he says. This led him to wonder if the A.D.A. had perverse consequences. "It's got to be widely pervasive and probably not talked about, because doctors are just getting squeezed further and further. This kind of patient will end up getting passed on and passed on, getting the runaround, not understanding why she's not getting good care."

It is difficult to know for sure if this is happening, but there is an analogous situation which has received considerable analysis. Economists Daron Acemoglu and Joshua Angrist studied how the A.D.A. affected employment among the disabled. Their conclusion was rather startling and makes Andrew Brooks's hunch ring plausible. Acemoglu and Angrist found that when the A.D.A. was enacted in 1992, it led to a sharp drop in the employment of disabled workers. Employers, concerned that they wouldn't be able to discipline or fire disabled workers who happened to be incompetent, simply avoided hiring them in the first place.

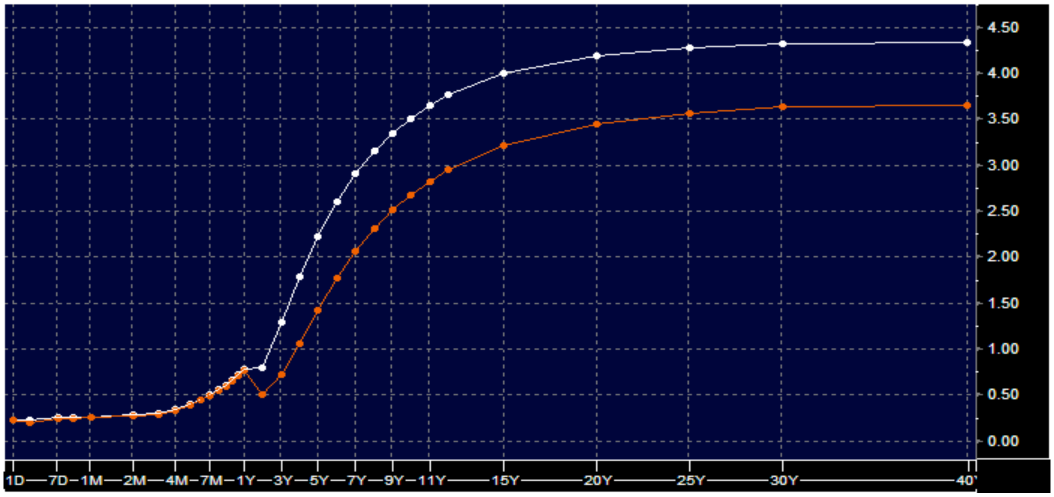
The phenomenon of actions producing outcomes diametrically opposite to those intended is often referred to as the Law of Unintended Consequences. A dramatic illustration of such misguided policy can be found in steps taken recently by the Federal Reserve under Chairman Ben Bernanke to keep short term interest rates near zero. By law, the Fed is charged with a dual mandate – to maintain price stability and full employment. These goals are often in conflict. In the past, stimulating job growth has often spurred inflation, while damping inflation through tight monetary policy has often precipitated a recession with a rise in unemployment. But Bernanke has achieved the dubious distinction of pursuing Quantitative Easing that is simultaneously reducing price stability while promoting the layoffs of more Americans than any merciless corporate chieftain. In the late 1990s Al Dunlap was CEO of Sunbeam Corp. He had previously achieved fame for having turned around such bloated companies as American Can, Lily Tulip and Crown Zellerbach, in each case by firing huge numbers of workers. The media dubbed him Chainsaw Al, although he personally preferred Rambo in Pinstripes. But the number of careers cut short by Al Dunlap pales into insignificance next to the job losses caused by "Chainsaw" Ben.

The second round of Quantitative Easing, dubbed QE2, was announced on November 3, 2010. This was a pledge by the Federal Reserve to purchase $600 billion of longer dated U.S. Treasury bonds. The objective was to stimulate the economy by keeping interest rates near zero. But longer term interest rates are not set by Fed policy. Rather, bond market participants set longer rates as an expression of their inflationary expectations. The higher inflation is expected to be, the more bond investors demand in interest payments to compensate for the loss of purchasing power caused by inflation. In the graph below we have charted the "yield curve" on two different dates – October 31, 2010, just before the announcement of QE2, and January 27, 2011, the date the Fed announced it was discontinuing further bond purchases. The yield curve is simply a graph which shows time to maturity on the x-axis, and the interest rate along the y, or vertical, axis. The lower curve displays the October, 2010 data. Note that in the roughly three months between these two dates short rates stayed near zero, but long term interest rates rose dramatically. In fact, this was the sharpest steepening of the yield curve ever. Bond investors have voted in unambiguous fashion that they anticipate higher inflation. (More on that later.)

Imagine, for a moment, that you are the CEO of a bank, trying to restore profitability after the crushing losses caused by the housing collapse. Given the record yield curve steepness, you can borrow from the Federal Reserve at an interest rate approaching zero, reinvest the funds in long maturity treasury bonds and earn nearly 4.5%. This simple strategy requires no loan officers, and will never result in a loan loss.

The Fed should have *raised* short term rates slightly, rather than lowering them. This would have indicated to the markets that the Fed is serious about its mandate to fight inflation. It almost certainly would not have dampened the economy, since anyone willing to borrow near 0% would not be deterred by 0.25-0.50%. The result would likely have been a drop in long rates, and a flattening of the yield curve. In that type of environment, a banker would be forced to make money the old-fashioned way – by lending money. Such loans are the lifeblood of small businesses, which after all create nearly all new jobs in the United States.

Treasury yield curve on 10/31/10 and 1/27/11



But the Fed's policies are resulting in job losses much more directly. Over the past several decades we have learned from painful experience that excessive money creation produces asset bubbles, although it is impossible to tell in advance which asset class will inflate. In the early 1990s, in order to combat the recession brought on by collapse of the savings & loan institutions, the Fed injected massive liquidity into the system. The resulting surge in stock prices generally and technology stocks in particular came to a painful end when the Fed finally instituted six consecutive interest rate increases. The dot.com bubble burst, and many investors lost vast portions of their portfolios.

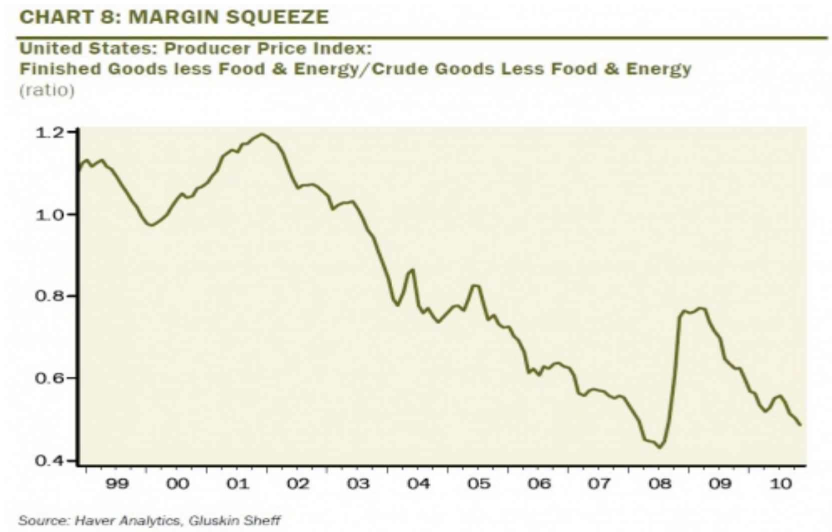
A few years later, in the aftermath of the attacks of September 11, 2001, the Fed again engineered a sharp boost in the money supply. The result was the housing bubble, whose collapse brought on the deepest economic downturn since the Great Depression and nearly caused the unraveling of the financial system

The Fed's response to the crisis was predictable – drive interest rates down to near zero and keep them there for years in the hope that housing prices will inflate. The result is inevitably another bubble, but this time in commodity prices. Precious metals prices are soaring: gold rose over 20% last year, silver more than 82% and palladium 91%. Oil prices rose 10%. Sharp increases in the cost of agricultural commodities have produced food riots in many countries around the world, as corn gained 26%, sugar 20% and coffee 61%. Such increases are by no means the exceptions. The spot market prices of barley, oranges, pork, beef, salmon, cotton, wool, rubber and copper are rocketing, to name but a few.

As company after company reported earnings for the fourth quarter of 2010, it sounded like they were all reading from the same script. Earnings were good, but the outlook going forward was for stiff headwinds. Input prices are rising sharply, and those higher raw material costs can not easily be pushed out to the consumer because of high unemployment.

Consider the recent (lack of) earnings release from Minneapolis-based grocery chain operator Supervalu, owner of Shaw's, Albertson's, Save-A-Lot and Jewel-Osco. Chief Executive Craig Herbert said that the company's major suppliers are raising prices from about 3% on the low end to 14% on the high end. Like most retailers, the company has been reluctant to raise prices. Supervalu is responding to the cost squeeze by maintaining a tight rein on costs. It closed 29 stores in the fourth quarter of 2010, roughly half of them in the Northeast, and cut 10% of its corporate staff.

Alcoa is traditionally the first company in the S&P 500 to report earnings each quarter. On January 11 the company reported good quarterly results aided by strong demand and higher aluminum prices. But on the quarterly conference call, Chief Financial Officer Charles McLane noted that higher raw material and energy costs ate away much of the benefit of higher prices and that he anticipates raw materials and energy to rise again in the first quarter. He went on. "We plan on continuing our aggressive focus on productivity improvements", a euphemism for more layoffs.



The chart above shows the ratio between finished goods and raw materials, excluding food and energy. The lower the graph, the more severe is the margin squeeze. And right now it is pretty severe. In addition to the companies cited above, AMR (parent of American Airlines) and Delta Airlines have warned of margin compression from soaring jet fuel prices, Campbell's and Dean Foods have cited rising prices of agricultural commodities for earnings misses. Kimberly Clark, warning of pulp inflation in its diapers, has announced the closing of several non-branded goods factories. Discount store operator Target, and teen retailer Hot Topic, have both announced layoffs to offset soaring cotton prices. There are hundreds of similar announcements across the landscape of American business.

It's almost impossible to imagine that the nation's top economic policy makers are not aware of the data we have cited, and yet they persist in forcing short rates down from near zero, despite creating greater unemployment to offset margin squeeze. What could their reasoning be? Perhaps, just perhaps, their motivation is political rather than economic. After all, the aggregate U.S. Government debt now totals roughly $14 trillion. Even a modest rise in rates of only 0.70% would add a trillion to this year's budget deficit. How would that look to voters in November, 2012?