2009 3rd Quarter Stock Market Commentary

UNCLE SAM, CEO

"The most terrifying words in the English language are:
I'm from the government and I'm here to help."
- Ronald Reagan

"Engine" Charlie, or Charles E. Wilson (as he was properly known), rose through the ranks at General Motors to become its President and Chief Executive Officer during World War II. He oversaw its transformation to produce vehicles to support the war effort, and its subsequent reversion to the world's largest industrial corporation. In late 1952, Wilson was tapped by President Eisenhower to be the Secretary of Defense. The political opposition and press were livid, on the grounds that this would inflate GM's already enormous political influence. After all, the company employed more workers than the total population of several states and was a key supplier of military vehicles. In a closed door confirmation hearing, Wilson was asked whether, given his huge GM stockholdings, he could ever be impartial enough to make a decision that would hurt the company. He replied. "I cannot conceive of one, because for years I thought what was good for our country was good for General Motors and vice versa. The difference did not exist. Our company is too big. It goes with the welfare of the country." This was simply a variation on what we now call "too big to fail." But it was misquoted in the newspaper accounts of the hearings (which no reporters attended) as "What is good for General Motors is good for the country," a misquote which has endured for more than half a century. The arrogance embodied in the misquote, and other verbal miscues, prompted Al Capp to base the character General Bullmoose in L'il Abner on Secretary Wilson.

Despite the diminished importance of the automobile industry to the American economy, once again it seems that what is good for Government Motors, oops, I mean General Motors (and Citicorp, Fannie Mae, Freddie Mac, American International Group and Chrysler) is good for the country. After all, we, collectively, own these companies and our own prosperity will depend, in part, on how well our investments in these corporate behemoths perform.

Do these government takeovers of private companies represent the death knell of American-style capitalism? Are once-great American enterprises doomed to operate in a Zombie-like state, like the Post Office, offering indifferent service at high cost? Or is this simply a transient period to get these companies through the current financial crisis before returning them once more to the private sector? It is instructive to look at the century-long history of the nationalization of individual companies or whole industries during time of war and financial crisis in order to decide.

On December 28, 1917, roughly eight months after the United States entered World War I, Woodrow Wilson issued the following proclamation.

Now, therefore, I, Woodrow Wilson, President of the United States, under and by the powers vested in me … do hereby … take possession and assume control … of each and every system of transportation … within the boundaries of the continental United States."

With the stroke of a pen, Wilson had nationalized the railroad industry to serve the war effort. In the fifty years prior to the war government policies promoted expansion of the railroads as a means to promote development. Collectively, railroads received land grants of 130 million acres, were able to use eminent domain to obtain track rights of way on an additional 50 million acres and received tax subsidies of $350 million. The result was an unrestrained expansion binge that resulted in far too many competitors carrying far too much debt. (Does this remind anyone of what happened when the government instituted policies to encourage homeownership?) Their principal competitive weapons were price cuts and secret rebates, which threatened the health of every company as their debt service became crushing.

Shippers were overjoyed at the disarray. With margins enhanced by low shipping costs, they lobbied state legislators aggressively. In a single year, 1913, 42 separate state legislatures passed 230 laws restricting railroad operations, mandating everything from extra crews to hours worked, grade crossings and signal lights. Shackled by antitrust laws, the railroads were powerless to fight back as a group. Faced with severe manpower shortages caused at first by limited workforce mobility and later by military conscription, railroads received annual wage increase demands from unions as high as 75% per year.

The reaction of the various constituencies affected by the seizure of the railroads was exactly opposite of what one might expect. Railroad owners, who might have been expected to be apoplectic at the prospect of the seizure of their companies, were overjoyed. For the first time, shipping rates could be set nationwide by the Interstate Commerce Commission, which was not subject to antitrust legislation, guaranteeing a positive return on capital. Bondholders were ecstatic, too, since their securities became obligations of the U.S. government. Unions were dismayed, however, as their wage demands became subject to government oversight. And shippers were forced to pay higher rates, and eliminate certain abusive practices, like reserving more railroad cars than they could load, ordering goods before they had contracted for railcar space to ship them, specifying freight routes, or sending cars from terminals which were not filled.

From the point of view of the war effort, nationalization was a success. Over 2 million troops were transported. Nearly 29,000,000 passenger train-miles were eliminated, resulting in considerable saving of coal. Physical resources were increased only modestly - the number of freight locomotives rose by 1.3%, while 2.5% more freight cars were added Yet the freight carried increased dramatically, as inefficient shippers were barred from using the rails and seven regional administrators coordinated the movement of trains from one railroad's track to another's.

In March, 1920, the railroads were returned to private ownership, although with a different competitive dynamic than before they were taken over. Post-nationalization, rates continued to be set by the ICC (Interstate Commerce Commission), guaranteeing a profit to each carrier independent of the quality of their management, or maintenance of their physical infrastructure. The result was an industry which was in a perpetual state of decay, leaving the United States with a passenger rail system that cannot hold a candle to European counterparts, and a freight system which occasionally leaves freight sidelined for weeks on end. All of this was accomplished at a cost to American taxpayers of $1,123,500,000, according to *War History of American Railroads*, by Walker Hines. And unlike today, in 1917, a billion dollars was a lot of money.

The railroads were not the only companies nationalized during World War I. The government also seized the telegraph companies and Smith & Wesson, all of which were returned to private ownership after the war. Interestingly, the government also attempted to operate a steel mill during the war to compete with private mills. It had sponsored a study which concluded that it was being overcharged for the steel plate used to build warships and that a 10,000 ton capacity mill could produce plate for 30% less than it was being charged. The plant was finished three years after the war had ended. It ran millions of dollars over budget and produced armor plate at twice the per ton cost that the steel companies were charging. It produced exactly one batch of steel and was shut down permanently.

World War II provided another opportunity for government to nationalize large swaths of the economy. It once again seized the railroads, in addition to coal mines and trucking companies. It briefly took possession of Montgomery Ward, at the time the nation's second largest retailer, although the taking was ruled illegal in United States v. Montgomery Ward & Co.

The Korean War provided another excuse to expand the reach of the government. President Harry S. Truman attempted to seize the steel industry to avert a strike that he claimed threatened the war effort, but the Supreme Court ruled in a case brought by Youngstown Sheet & Tube that the desire to avoid labor strife was insufficient grounds to abrogate private property rights.

War has not been the only pretext, though, for the government to take over private industry. The situation most analogous to the current crisis was the Great Depression. Prompted by the stock market crash of October 29, 1929, commercial activity plummeted around the world. Unemployment in the United States reached an astonishing 25% in 1933 (compared to today's rate near 10%), more than 5,000 banks failed (exactly 25 banks failed in 2008 and it is estimated that 100 more will fail this year), and gross national product fell 8.5% in 1931, 9.5% in 1932 and another 2.5% in 1933 (contrasted with a less than 4% total decline in the current crisis). The Roosevelt administration responded aggressively, passing the Emergency Relief and Construction Act to create massive public works projects, and creating the Reconstruction Finance Corporation, which made loans to distressed banks and bought stock in over 6,000 banks at a cost to the government of roughly $3 billion. This would be equivalent to $500 billion in today's dollars, a fraction of what the government is spending to deal with a crisis of considerably smaller magnitude.

At around the same time, Congress passed the Tennessee Valley Authority Act, seizing the assets of the former Tennessee Valley Electric Company. The TVA has grown into the nation's largest public power company, generating and distributing power to nearly 9 million residents of the Tennessee Valley. In a broad context, this undertaking was a big success. The rural area it served had massive unemployment, the average annual income was less than $650/year, malaria was rampant, and the land had become depleted by poor farming methods. The TVA hired the unemployed and began a massive set of construction projects, building dams to ensure flood control and power plants to bring reliable electricity to the region. They taught modern farming methods, like the use of fertilizer and crop rotation, to landowners. As is always the case with massive projects, there were adverse consequences for many. More than 15,000 families were displaced from their homes, and numerous independent power generating and distribution companies failed, unable to compete with a government sponsored enterprise. In a recent study of the TVA by Gary D. Ferrier of the University of Arkansas and E. Tylor Claggett of Southeast University, the researchers found that TVA and its distributors did distribute power reliably, but, as in almost everything done under government auspices, they spent too much money and employed too many people to do so. That may be acceptable for a natural monopoly like an electric utility, but it will never permit General Motors to compete effectively with world class Japanese competitors.

It seems that every crisis now revives the political impulse to think that the government should step in and take over. In the 1970s it created Amtrak from the wreckage of the bankrupt Penn Central Railroad. The government is Amtrak's only shareholder. Its chairman, CEO, and Board of Directors have often included political appointees with no railroad experience. Needless to say, Amtrak has never been able to return to financial stability. The government also assumed control of the foundering Continental Illinois Bank in 1984, which was sold a decade later to BankAmerica. It formed the Resolution Trust Corporation in 1989 to deal with the collapse of S&Ls, taking over more than 1,000 institutions.

This brings us to the present, where the government already controls significant players in the automobile and banking industries (and soon hopes to add health care). What lessons can we glean from studying previous nationalizations?

First, despite dire warnings by conservative commentators that the government's ownership stakes in General Motors and Citigroup, et al, mark the end of capitalism, history suggest otherwise. In almost every case (TVA and Amtrak being the notable exceptions), companies nationalized because of war or economic crises have ultimately been returned to private ownership. With the exception of Fannie Mae and Freddie Mac, which never should have been private in the first place, this is the likely outcome now.

Second, industrial seizures have generally been successful at accomplishing the short-term objective which prompted the taking – the rationing of scarce materials, the production and movement of goods during wartime, or the stabilization of financial institutions during economic crises. Undoubtedly, the stunning stock market rally off the March 9 low reflects the realization that the steps taken have pulled the economy back from the precipice on which it was teetering. The healing process has begun.

But the history of companies that have been nationalized shows that government is good at making political, but not business, decisions. If the long term financial health of General Motors, for example, would require the shutting down of a plant employing several thousand workers, is that a decision that is likely to be made by a Congressman facing re-election in less than two years? If certain branches of Citigroup or Bank of America serving minority neighborhoods are unprofitable, would either company be permitted to close them? Will either bank be allowed to pay compensation that will allow them to compete with Goldman Sachs for top talent? These are not simply idle fears. Every auto plant built in the United States over the past twenty years, whether from Toyota, Nissan, BMW or Kia, has been located in the South, primarily because hourly wages are less than half of those paid in Detroit. But notice that in June, when GM, under the control of the new car czar, announced the location of a new facility for the manufacture of a small car, it chose Orion Township, Michigan, rather than the now idled Saturn plant in Spring Hill, Tennessee. I am sure the decision was based solely on economics, and that UAW support of the administration played no role. Aren't you?

At the market's low on March 9, stocks were priced for the most dire of scenarios. Aggressive action was necessary and effective, and thus it seems appropriate that there was a rally to reflect a more normal level of profitability. But now that the acute stage of the crisis is past, government needs to reverse course quickly. After all, who will invest in Ford Motor Co if their principal competitor has government support? Recall the structural advantage that Fannie Mae held over other mortgage packagers because of the lower cost of financing that accompanied implicit government support. I suspect the higher market prices after the rally of the last half-year do not reflect the low level of profitability that would accompany years of business decisions being made by bureaucrats.