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Obama and the Wrong Choice 3-16-09

Investors appeared to have perceived the 39% decline in the S&P 500 from its October 9, 2007 high of 1565 to 1005 on November 5, 2008 and the associated earnings loss as temporary – much like they viewed the effects of prior recessions and bear markets. Downward momentum may have pushed the market somewhat lower but instead the market broke and fell another one-third to 677 on March 9.

Investors, post-November 5, 2008, appear to have decided that the discounted loss in revenues and earnings from lower corporate unit sales will be permanent. That is the conclusion one derives from the nearly 57% decline from the October 2007 high.

Reason: the Obama Administration implemented the incorrect model. The Keynes model was pulled out from the 1930s which posited that as the private sector levers down its balance sheet, the public sector must lever up its balance sheet. Their interpretation – huge increases in Federal government spending and new Federal government initiatives and entitlements such as national health care.

The correct model for the current situation: focus on opening credit markets, which the Federal Reserve is doing, and removing the hard-to-value assets from the balance sheets of financial entities, which the Treasury is still working on. The third leg of the stool would be to encourage recovery and enhance incentives by lowering marginal tax rates at the personal and corporate level.

Obama's proposed 10-year budget has Federal outlays at 27.7% of GDP in 2009 (compared to 21% in 2008,) but then falling to 22.2% in 2012. No one believes that enacting new entitlement programs such as national health care will allow Federal outlays to decline to 22% of GDP. Instead the government's market share is expected to remain high as the programs move the U.S. toward the European model.

Implication – the Federal government crowds out the private sector. In turn that implies a permanent loss in unit sales volume and earnings by the corporate sector and accounts for the one-third drop in the S&P 500 since Election Day. It isn't possible to shrink the market share for the private sector without constraining corporate revenue streams.

President Obama is attempting to implement exactly the wrong model at a critical point in the American economy. One hopes he can modify his model for how the economy actually works so that the equity market can recover.

The $787 billion stimulus program helped push equities lower in 2009. That program is aimed at promoting economic growth in 2010, not 2009 as the Congressional Budget Office said. Consumer spending is needed in 2009.

Had Congress and the Administration wanted a program to encourage economic growth in 2009, that could have been accomplished by a Federal income tax and/or Social Security tax holiday. And then to reduce the inventory of unsold single-family houses a sizeable large tax credit could have been granted to buyers. Result – the Federal Reserve is doing the heavy lifting in 2009 while Treasury continues to work on a plan.

Capacity utilization for total industry was at 70.9% in February -- the low set in December 1982. That low rate is one more signal of downward pressure on selling prices in 2009. Global excess capacity is high while net worth declines have set back global consumer spending.