The Schizophrenic Nation

November 2010

Sitting back to reflect on the recent election and Federal Reserve announcement has got the Armchair a bit perplexed. It was great fireworks and theater all in one little week. Trying to interpret and project such high drama is a bit intimidating, but let's give it try.

Depending on your political persuasion the election results have you either giddy or in a deep funk. The Armchair will defer to what seems like the most enduring perspective of the last ten or so years…**Be careful what you wish for, because you just might get it**. It seems everything we do these days is filled with unintended consequences.

A government divided is not likely to resolve our long list of challenges. There are just way too many constituent groups with their hands firmly ensconced in the taxpayer cookie jar. The best we can hope for is both political parties fearing retribution in two years if quantifiable progress is not made before, so maybe they will work together to save themselves. The Armchair wouldn't take that bet. Odds are the most productive collaboration will yield just a few more Band-Aids for our economic head wound.

Who in Washington is ready to force senior and Baby Boomer voters to take a cut in retirement and/or health care benefits because the current systems are unsustainable? Who is going to materially cut government union workers, worker pay, and government retiree benefits? Who is going to privatize the bankrupt Post Office or dismantle the dead broke mortgage black holes, Fannie and Freddie? Who is going to toss out most of the IRS by initiating more common sense tax policy? Who is going to cut defense spending when most of the defense budget supports American jobs? And who is going to raise taxes or cut spending in a meaningful way to resolve fiscal deficiencies?

It seems naive to think we can make a worthwhile dent in this mess with a Democrat President, a Democrat Senate and a Republican House all working together...as if. How contentious will it become if the new conservatives start demanding a repeal of Obamacare, engage in constitutional gamesmanship, withdraw social safety net support and maybe resurrect the birth certificate issue? That's going to get us productive collaboration?

The recent election suggests the tide of entitlement and Big Brother growth may soon slow, but all the Republicans seem able to pledge is a $100B cut from the Federal Budget, a mere ten percent of our current annual budget deficit. Wow! Now that's leadership, atta boy folks, some real change to hope for! We're going to maybe save a dime for every dollar we don't have, but will still be spending.

The amazing 180-degree shift in voter thinking surely shows our national insecurity. Vote for hope and change! Then two years later, vote to change the hope and change. What happens if in the next two years economic prosperity doesn't fall back in our collective lap?

Since it would seem our political agenda is too confused, and our politicians too bipartisan, the Federal Reserve has emerged from the phone booth donning their Superman uniform. Of course since one rarely sees a phone booth anymore maybe there really isn't a Superman. But there is a volunteer to be our newest superhero - Helicopter Ben.

For some time, Federal Reserve Chairman Ben Bernanke has been referred to as Helicopter Ben because years ago he pledged that if Japan style deflation tried to rear its ugly head he would rain down money from above. Over the current economic villain he has rained his latest attempt, QE2, in support of the Fed's two primary mandates - to best manage inflation and employment.

How many remember that just a few short months ago talk within the Federal Reserve and investment markets was focused on withdrawing the first attempt at Quantitative Easing? Opps! Not long ago green shoots seemed to point to better days ahead. But those green shoots have yet to sprout any worthwhile harvest. Instead, the fertilizer from QE1 seems to have fruitlessly washed away.

Unemployment is still hovering around 10% despite claims that previous stimuli would cause it to fall measurably. Since half of the Fed's mandate is to inspire employment, it must take action. So like voters, the Fed has changed course, returning to the printing press. The pump just needs more priming!

The other half of the Fed's job is to keep a vigilant eye on inflation, the villain that destroys our purchasing power. It would seem that goods inflation was long ago destroyed by globalization. Goods producers moving to cheaper production markets continue to keep a firm cap on consumer goods prices. Even the massive 2007-2008 run-up in commodity prices didn't inspire lasting consumer goods inflation. This is not the red light flashing on the Fed's inflation radar screen. That flashing red light today is deflation, and mostly the deflation in asset values.

One might suggest the inflation destruction in consumer goods may have helped enable inflation in asset prices. Why? Maybe as goods prices fell, people felt they had more money in their pockets. This extra discretionary capital found its way into the investment market. Home values and all things consumer benefited, as did the stock market. Investment gains in housing and equities inspired more investment capital. Too much capital chasing too few goods can lead to inflation. In this case it was asset inflation, from home values to PE ratios.

Prosperity also lent a helping hand. As globalization reduced the price of consumer goods and investment gains filled our balance sheets we began to feel more prosperous. And as readers of the Armchair have heard before and will likely hear again and again and again…**There is nothing like prosperity to numb the mind of self-discipline**.

That prosperity inspired us to lower credit standards and mandate banks to lend money to people who couldn't really pay it back. It allowed the ever-powerful bankers running the Treasury to conjure up a regulatory framework that set the stage for financial fiduciaries to evolve into casinos…casinos that could bet alongside their own customers. Consider the results we have today - assets with more debt than value, a high fixed cost society that can't afford to pay its current and future bills and fragile investment markets at constant risk from the overly influential trigger happy investor class.

To the Armchair, QE2 boils down to one thing, tied to both parts of the Fed's mandate: it's about stemming the outgoing tide, reducing the pace of asset deflation and job loss.

We are trying to prop up both the asset value and employment markets, which significantly support the broader economy, hoping that better days will soon return. It's like the President said with his first fiscal stimulus – this is going to create or SAVE jobs. We're not in the game of creating right now. We're in the game of saving…saving asset values from falling below their indebtedness, saving jobs by stoking any economic activity we can and saving the average investor/saver since his balance sheet can't support retirement. QE2 is trying to add more sandbags to the dam protecting us from the flood of deflation, the destruction of bank balance sheets and the country's challenges from declining prosperity.

An old Armchair perspective might best explain all this frantic fiscal and monetary arm waving…**Both economic expansions and contractions have a tendency to feed off themselves**. Expansions benefit from an ever-increasing velocity of demand. Contractions suffer from just the opposite.

What the Fed and Washington have obviously been trying to do is create the tipping point, searching for the catalyst that moves us from the contraction to the expansion path. Why their actions aren't working will be for our grandchildren to study. One outcome will likely be new economic theory to apply the next time, which like Keynesian theory this time, may not really apply.

The other challenge we face is that prospect of unintended consequences. The dollar is the world's reserve currency. To date American consumers have done the heavy lifting for the export oriented global growth economies. And American foreign policy, whether embraced or despised, is the cornerstone of global security and a vital infrastructure for global trade and prosperity. All changes that occur in America reverberate around the world, to the benefit of some and the detriment of others. At this stage it is difficult to project the ripple effect when the 800-pound gorilla dives into the backyard swimming pool.

Today's economy is like no other in human history. At no other time have we been so globally interconnected, which makes us globally interdependent. All sorts of unique economic influences and stress points exist today, for which we have no legacy systems to manage. There is little globally coordinated economic policy, yet there is a globally working economy. We are witnessing and living the chaotic trial-by-fire attempts to manage something with which we have little experience.

We only really know that which we have personally experienced. Everything else is just book learning, of little value in the heat of battle. Combat instincts come from personal experience, not books. And if we have little experience with a production and trade market that includes the entire world, it is tough, perhaps even naïve, to believe we are in control. So when things don't go as expected we quickly move from one idea to another, grasping for straws in this schizophrenic nation.

What's the solution? Well, the "professionals" are likely going to call for more therapy, here and everywhere the next sneeze may be heard. Certainly there are more prescriptions sitting in our economic pharmacy. If one quick remedy can't be found, we'll just try another. At some point though, we may require more shock therapy, whether self-induced or not.

One way or another we will get past this. But since WWII was the catalyst that got us through our most recent similar circumstance, we might consider hoarding a few acorns for a possible economic winter, because today may just be the colorful fall.

Doug

Douglas A. Leyendecker
713-862-3030
doug@armchaireco.com