ARMCHAIR ECONOMIC PERSPECTIVE
The Sea of Conundrum
July 2009

Warren Buffet is famous for saying, “The rising tide lifts all ships but when the tide goes out you can tell who has been swimming naked”. I like to say it a different way. “The rising tide lifts all ships but when the tide goes out you can tell which Captains navigated themselves on to a reef.” During the hurricane of economic contraction, leverage sinks many a ship.

Navigating this economic storm has become quite challenging even for the seemingly well Captained. The great AIG and Lehman have sunk. Even the mighty GE has been threatened. The Fed has been pummeled.

Washington is frantic to keep interest rates low, to help banks and consumers recapitalize, to inspire more home sales, auto sales and general economic activity. Through fiscal and monetary policy, bailouts and takeovers, our Admirals seek to provide a significant supply of cheap economic fuel. But we are still surrounded by many reefs, anxious to thrash us into the salty caldron. And no matter what we read about “green shoots”, it is still hurricane season.

Company revenues all over the country are declining. You don’t add employees or build cash as revenues fall. Thank goodness the public capital markets are currently back in business, allowing savvy Captains the chance to stockpile more fuel.

Many homeowners have been able to add a little fuel to their stores as low mortgage rates inspired refinancings. But alas, that mortgage rate ship now drifts in the doldrums. Long rates are up. Refinancings are down significantly. Herein lies one of the reefs in the Sea of Conundrum.

Lately, investors have demanded higher rates for longer dated Treasuries. There are several theories as to why. The optimists suggest this is a sign the economy is getting better, that markets are moving back to normal. The pessimists fear an exploding money supply will induce inflation. Others suggest allocation growth towards higher risk asset classes, equities and commodities, is draining liquidity from Treasuries. Only time will give us the real answer.

In reaction to the recent rate rise, the Fed suggested it would not expand its program to purchase monetary assets: in essence no longer manipulating interest rates lower, no more Quantitative Easing (QE). Many seem to think the Fed was just saying what the market needed to hear. They believe the Fed’s only course of action will be a return to QE. We need lower rates to inspire economic activity. But if the Fed goes back to QE then investment sharks are going to smell the blood of inflation, demanding more return for their capital.

Even if Washington stops QE it still has to sell an enormous Armada of sovereign debt to finance our stimulus. Selling record amounts of debt in a massively contracted investment capital market would seem to have only one end, rising interest rates. You can’t cheat the Mother Nature of supply and demand. More debt issuance + less investment capital = higher rates.

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It seems there is no course but higher interest rates, which will surely choke off economic recovery. If refinancings collapse at today's rates, what happens when they go higher? We seem to be in a damned if you do, damned if you don't situation….a conundrum.

There are many more reefs in this Sea of Conundrum.

Lower interest rates lead to a lower dollar, which leads to higher oil prices, which leads to more economic challenge. Higher interest rates lead to a higher dollar, which makes American exports more expensive, which leads to more economic challenge. Here we have the world's Reserve Currency Conundrum.

Then there's our Creditor Conundrum. We can't inflate ourselves out of debt without causing significant pain to our major creditors in China and Japan. Any hint of cheating them out of their due and our Treasuries could walk the plank, causing a free fall in our currency.

The list goes on….

Can we really reduce health care costs while expanding coverage as the baby boomers age?

How can we enact any carbon policy that doesn't come with higher taxes or cost of living?

How does increased regulation lead to lower costs to businesses and consumers?

How do state and local governments fund their deficits without tax increases?

When did government become more efficient than the private sector at allocating capital?

Increase taxes, increase costs, increase regulation and expand government all while unemployment grows, incomes fall and consumers retreat into their turtle shells? Has our storage of rum in the Washington hold been spiked with magic mushroom? That's some powerful Kool-Aide. Ahhh…the Leadership Conundrum.

All is better says the recent stock market. But maybe we're just in the eye of the hurricane. I've been there. In 1983 I drove around Houston in the eye of Hurricane Alicia. Everything was calm, quiet and serene. You could see the damage, the storm had passed, or so I thought.

I hope during this challenging environment you find some favorable opportunity. If so, keep a firm grip on the wheel, for it is hurricane season. There are two sides to every hurricane, likely more on the horizon and the Sea of Conundrum is teeming with reefs.

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