



STUART INVESTMENT
MANAGEMENT LIMITED

The Stimulus Package, the Budget and the Economy: An Update

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March 2, 2009*

Introduction and Summary

Several key factors led to the current financial crisis and severe economic downturn:

- Lax lending practices developed in the context of an inadequate regulatory framework, poor oversight and enforcement.
- Households took on excessive debt levels to maintain their consumption at an unsustainable level.
- Lenders exhibited ignorance and hubris regarding risk.
- Excessive leverage was used relative to the risk taken.

In addition, a long-standing propensity to grow the economy by fostering consumption at the expense of investment makes it more difficult to return to a favorable growth path. The use of external (foreign) debt to finance this consumption also adds to difficulty of returning to a sustainable period of growth in U.S. household living standards.

There are many views on what should be done. I have distilled them into three “representative” extremes to highlight what I believe to be their key plusses and minuses. I have, however, restricted my discussion to how dealing with the economy as opposed to the economic crisis as the latter requires a separate lengthy report.

Alternatives considered are:

- Do nothing, either to bail out the financial system or in the way of a stimulus package.
- Recapitalize the banking system and devote the stimulus package solely to tax cuts
- Recapitalize the banking system and devote the stimulus package to government spending in support of job-creating projects.

The package is, of course a combination of alternatives two and three.

The stimulus package is divided into three parts, tax cuts, direct spending for infrastructure and spending to broaden the safety net. In connection with spending categories I discuss the Administration/Democratically-controlled Congressional attempt to rebalance and combine the longer-term social solutions with the immediate need to

spend in a way to create the most jobs. This attempt is by far the most important reason why the Republicans did not support the package.

The package will mitigate the current economic downturn but may not reverse it sufficiently without more stimulus. It will save many jobs and create some but, over the next 6 to 9 months, it will not reverse the rise in unemployment. The unemployment rate seems headed for 9 to 10 percent. Excess labor and capital will likely keep price pressures absent for the next two years. However, dollar risk against some currencies, Asian resource demand and somewhat lower productivity as private investment flags could lead to inflationary pressures once demand recovers sufficiently.

Regarding equities, the scope of the downturn, the increase in the role of government needed to recover, post crisis regulation to limit re-leveraging, and the need to raise revenue to fund future social security and Medicare will make it difficult to sustain the type of recovery in equity prices that the U.S. has generally enjoyed coming out of a recession. Post-tax profits are not likely to recover to the 2007 levels for many years.

Following my treatment of the economy and stimulus impact, I discuss what I think is the “root” of much of our longer-term economic problem, inadequate investment. My biggest concern is the lack of emphasis on this factor in the public debate in shaping the stimulus package and the long-term budget. This section involves the need to integrate the nation’s short-term job-creating need with the longer-term need to finance our legacy obligations for Social Security and Medicare. It also takes into consideration our rising external debt and the problems this creates.

In connection with the economic and impact discussions and the need to reorient to investment from consumption, I also comment on aspects of the President’s just-released ten-year budget projection. The proposal reverses the Bush policies which favored the rich over the middle class. Its liability is to propose tax increases on the wealthy at a precarious time for the economy. However, some of the components of the budget do begin to address long-term need to fund our longer-term social security and Medicare obligations. Despite the liability of presenting the “hard budgetary truth” at a very difficult time, it is probably best to get the Administration’s game plan for dealing with the situation out in the open sooner rather than later. However, in my opinion, the budget does not go far enough to restrict consumption and promote the investment needed to support future obligations.

Causes of the downturn

Several key factors led to the current financial crisis and severe economic contraction that is already the worst since the depression. For the most part the factors are different from those in the depression although complacency, lack of adequate regulation and excessive leverage are similar. Still, in many ways today’s situation is more complex than the depression. This complexity was fostered by the development of complex derivatives that made it difficult to assess the potential for a market failure although many observers warned of the possibility. And indeed the ease with which the U.S. recovered from the

1987 stock market crash and the Long Term Capital failure contributed to the notion that derivatives, though complex, would not be a source of market failure.

Specifically, I see the main contributors as:

- Lax lending practices, developed in the context of an inadequate regulatory framework, poor oversight and enforcement, especially in housing;
- Households taking on excessive debt levels to maintain their consumption at an unsustainable level with little regard to how the debt would be serviced in a time of financial stress;
- Ignorance and hubris regarding the risk of holding debt that was inadequately vetted; and,
- Excessive leverage used to boost returns under the assumption that default risk was negligible.

A sluggish economy, inadequate collateral and the inability of many sub-prime and alt-A borrowers to service their mortgages raised default levels to a level that made the portfolios of highly-leveraged holders of these mortgages unprofitable. As leveraged creditors, both bank and non-bank institutions observed the situation, they all tried to sell their paper at once. Because of the extreme leverage, market prices fell so fast that the underlying capital supporting their more vulnerable positions was quickly exhausted, forcing more selling. This in turn caused more valuable assets, loans with much lower default rates, to be sold to support positions. Paper of all quality fell quickly, forcing many holders into insolvency. As a result, the credit-driven nature of the U.S. and, to some extent, world economic growth, was brought to a halt as many of the normal lenders needed their capital to support “toxic” positions they could not sell.

As will be discussed in a later section, a long-standing propensity to grow the economy by fostering consumption at the expense of investment makes it more difficult to return to a favorable growth path. The use of external (foreign) debt to finance this consumption will also add to difficulty of returning to a sustainable period of growth in U.S. household living standards.

Competing views on how to fix the economy

An oft question is whether it is more important to concentrate on restoring a healthy banking system or to create demand. In my opinion the answer is we must do both. The former facilitates lending that contributes to growth and a free-market, credit-driven economy like ours can not grow without a sophisticated, lending mechanism for converting savings to efficient investments. However, a lack of demand destroys the incentive to invest and produce. So the two components of recovery are inseparable.

Do nothing: The argument of many “free-market” ideologues is that we should do nothing and that the market will correct itself. Even if that were true (unlikely since all market-based theories that I am aware of allow for market failure), as Keynes (a monetarist) pointed out “in the long run we are all dead”. The context of this remark was

that the market-correcting mechanisms might take so long to work out that the resulting social damage is unacceptable. That is, in my opinion the situation we are in now.

To support that case simply look at the GDP data following the 1929 market crash. In the subsequent three years, 1930, 31, and 32, the economy contracted by 9%, 6% and 13% and the unemployment rate rose to 25%!!

Recapitalize the banks and use tax cuts to rekindle demand: Tax cuts were the means to extricate the U.S. economy in the much-milder recession of 2001 and, because they were long lasting (not permanent since they were set to expire after 10 years), they had the desired economic effect. The benefit of tax cuts is the known effect of stimulating the economy. So-called supply-side economists (I am one) maintain that tax policy can be used both to stimulate the economy and to make it operate more efficiently, thus providing a bigger economic pie for a given amount of resources. One of the main tenets of this thinking is that policies should be permanent and known, not ad hoc, as was the case in 2008.

Unfortunately, the popular wisdom that has captured the “political – government is bad” supply-siders is that tax cuts are the only positive method for stimulating the economy. The problem with relying solely on this approach in the current environment is that tax cuts to households would favor consumption over investment at a time when our growing external and domestic debt as well as future Social Security and Medicare obligations demand a reallocation to investment from consumption (see “the case for investment” section below). Further, there is a suspicion that in the current climate where consumer and business confidence are flagging, too much of the money would be saved without creating the investment needed to use savings effectively.

Another “political” reason for not relying on tax cuts is the realization that a disproportionate portion of the benefits went to higher-income households. Indeed the recovery of 2002-2008 was the first one in post WW2 history when the mean income went up while the median income fell. As indicated in the just-released budget proposal, the share of income received by the top one percent of households rose from 10 to 20% from 1980 to 2008. Much of that rise occurred during the robust growth of the 1990’s, despite the reversal of some of the tax cuts for higher incomes during the Clinton administration.

The current administration accepts the notion that that tax cuts are a useful resource for reviving the economy. Approximately 38% of the cost of the recently-passed **stimulus** package is due to tax cuts. But in a different emphasis, the 10-year **budget** proposal retains tax cuts for households with income up to just above \$200,000, but raises tax rates and cuts deductions on higher incomes. Both the stimulus package and the budget are skewed to improving the lot of lower-to-middle income households.

Recapitalize the banks and devote the stimulus package to job-creating spending projects on both the private and public sectors: The Keynesian solution to reviving the economy, fiscal spending, has gone out of favor over the past two decades. The

conventional wisdom is that New Deal policies did not work and contributed little to a lasting economic solution. And in the post WW2 period, pent-up consumer demand and the expanding use of credit, coupled with tax cuts have generally been sufficient to create enough demand to grow the economy. Recall, however, that tax rates were quite high following the war and household debt levels were low relative to potential income. Thus broad-based, permanent Kennedy-type tax cuts were a superior way to stimulate the economy. Further, public spending was used mostly to reallocate resources both to build a post-war safety net, but also to favor political constituencies.

Unfortunately, the U.S. is no longer in the post WW2 situation of low private debt levels. Further, the tax cuts that have been enacted in the past 3 decades have left the U.S. with a with inadequate public investment for maintaining necessary infrastructure, both of the traditional, roads, buildings and bridges type, but also an information highway that competes favorably in the world economy. Further, safety net programs, including health care and social insurance are either inadequate or are inadequately funded. A prime example in health care is that the burden of care often falls on businesses that are trying to compete in a world economy where many countries provide the care, thus substantially reducing both current and legacy costs to private business. And as businesses have increasingly shed this cost in order to successfully compete, many workers are left without sufficient health insurance or care. Along with education, health care is critical for maintaining productivity, since human capital (labor) accounts for nearly 70 percent of GDP production.

Given the multi-decade shifting of resources favoring the consuming end of the private sector, the administration concluded that spending on a variety of projects must be a major part of the job-creating strategy. With the backing of the Democratic Congress, the administration was able to enact a stimulus package that combines tax cuts and fiscal spending to save and create jobs.

The \$789.2 billion package

The \$789.2 billion stimulus package that was passed ended up, according to the Wall Street Journal, being 38% tax cuts, 24% spending for research and infrastructure, and 38% aiding various groups such as the unemployed and students. Much of the spending for infrastructure and aid will be in the form of grants to states to alleviate state and local budget deficits. Thus, much of the impact will be to save, rather than create jobs.

Many observers have criticized the administration for not targeting the funds solely to tax cuts and infrastructure. However, the administration had to balance the current critical need to revive the economy with its longer-term objective of reversing the decline in public services and the safety net that have occurred over the past three decades. While this is not the focus of this report, this balancing act is the subject of David Leonhardt's "The Big Fix", in the January 27 issue of the NYT's Sunday magazine.

The majority of the approximately \$300 billion in tax cuts, \$186 billion, goes to lower and middle income households in the form of a tax credit and relief from the alternative

tax. Surprisingly, only \$6.6 billion goes to tax relief for home purchases as the final bill limited benefits to a small group of first-time-only purchasers. A very small amount, \$5.1 billion went to business incentives.

The \$190 billion devoted to infrastructure spending is distributed broadly between public transportation (\$16.4 billion), roads and bridges (\$29 billion), health research and productivity investment (\$27.5 billion), utility modernization and energy conservation and investment (\$43.5 billion), and other investments in the environment, much of it related to water safety, flood prevention and cleanup.

\$300 billion of the stimulus package is devoted to aid that amounts to at least a temporary rebuilding of the safety net. The largest component by far is an \$87 billion dollar increase in federal spending for Medicaid. As with a lot of the aid, much will, unfortunately, go to fill a gap created by revenue losses at the state and local level. \$27 billion is devoted to extending UI benefits, \$2 billion is for rehabilitating foreclosed and vacant properties, \$8 billion for state aid to support public safety and critical services (saving and creating police and related jobs), and most of the rest is devoted to education preservation.

A key objective and potential measure of the effectiveness of the stimulus package is the number of jobs saved or created. It is impossible to measure the impact because we can not observe how many would have been lost in the absence of the package. Over three million jobs were lost last year and at least that many were expected to disappear in 2009 in the absence of the stimulus package. Mark Zandi, Chief Economist at Moody's Economy.com suggests three million jobs may be lost this year, vs. 4 million that might have been lost in the absence of the program. Over the life of the stimulus package, the effect of which will extend into 2010, Zandi expects about 2.2 million jobs to be saved or created, about half of what the administration estimates. Assuming the banking system in "cleaned up" quickly (a big if), he looks for the stimulus package to halve the number of monthly job losses from 500,000 to 250,000 in the second half.

Actual job losses will be impossible to measure and many of those weigh in will have an agenda and spin their answer accordingly. And although Zandi was an economic advisor to McCain, I chose to cite him because I consider his estimates reasonably unbiased and competent. They are also consistent with my own "rule of thumb" notions of the relationship between spending, tax cuts and employment. What strikes me, though, is that the job estimate is quite pessimistic relative to those being lost in the contraction we are experiencing. This is a major factor in my own conclusion (fear) that the package will only mitigate, not reverse the downturn.

The economic outlook and likely impact of the stimulus package

Growth and Jobs: The economy is currently declining at approximately 5-6% rate. The GDP contraction in the fourth quarter, 2008 was revised up to a higher-than-expected annualized 6.2% rate, and the further contraction in the first half of 2009 is likely to remain near that level. While the contraction in the fourth quarter was due to a sharp drop in end-use demand, the contraction in the first half will be more due to the further

contraction in production and investment as businesses adjust to reduced consumer demand and expectations. Rising unemployment and falling housing and stock prices will take a further toll on consumer demand.

Near term, the stimulus package will slow the downturn, but not reverse it. The initial, indirect reaction to the package is disappointing. One might have expected a psychological boost to confidence and equity markets simply from the passage of a demand-creating stimulus. Instead, both consumer confidence and equity prices have fallen to new lows. Despite some easing of credit from ongoing efforts to improve and recapitalize the banking system, only the most credit-worthy borrowers have access to the markets and the continued, understandable tightening of credit standards is offsetting the impact of lower mortgage rates. And banks are still struggling to build capital as default rates on credit card debt and concern over commercial loans continue to boost loan-loss reserves.

The main direct impacts of the stimulus package in mitigating the downturn are:

- An increase in safety net funds that, by their nature, replace only a fraction of the income lost.
- Tax cuts that will begin to add to household income in April but are small relative to the downturn we are experiencing.
- Budgetary transfers to states that will save jobs in education, police protection, health care and other areas, and
- Infrastructure spending that will increase slowly through the year and hit its “spending stride” in 2010.

On balance, I think the data will ultimately indicate the need for a further, substantial stimulus package that will delay the time when the administration can reverse the rise in the budget deficit.

Looking beyond six months, the current thinking of those forecasters to whom I give weight is mixed. David Rosenberg, whose forecasts regarding the downturn have been quite prescient, looks for a rebound in the second half, with growth near 3% due to the cumulating impact of the stimulus package, but then forecasts growth in 2010 to slip back to less than 1.5%, far below potential. He sees unemployment leveling out between 10 and 11%. If correct, then another stimulus package will almost certainly have to be passed to further bolster the economy in 2010. While David’s forecast appears pessimistic, other forecasters I respect see more of an “L” recession with little or no pick-up in the second half of 2010.

My view is similar to David’s but a bit biased to the pessimistic side with respect to the second half of 2009. If I am correct, another stimulus package will be passed yet this year. The Fed’s updated mid-year forecast in July may well set the tone for determining the need for, size and composition of a follow-on stimulus package.

As indicated in the previous section, the administrations job forecast assumes 4 million jobs will be saved or created in the, say, 18 months the stimulus package is being implemented. I am more comfortable with Zandi’s forecast in the 2-2.5 million range. If

correct, then another 3 million jobs will be lost this year, most of which will come in the first half. This implies job losses will fall from the current level near 600,000 per month (Rosenberg is forecasting that the Friday, March 6th report will show a 700,000 loss in February). Since all credible forecasters expect further losses in the second half of 2009, losses for the remaining four months of the first half will have to trend down pretty quickly. I am comfortable with this as a base case since job losses surrounding yearend tend to be heavier than in other months. Still, the risk to my base case is for bigger losses. The unemployment rate is likely to be in the 9-10% level by the end of the year. And some states, for example, California the rate is already above 10%!

The budget: Given my pessimistic view of the economy and the need for more stimulus, I think the Administration's budget projections are very optimistic. Their 10-year forecast assumes 2009 and 2010 deficits of \$1,752 and \$912 trillion and then declining deficits to \$533 in 2013 before a gradual increase due to rising Social Security and Medicare payouts. If I am correct and more stimulus is needed, then the 2010 budget is likely to again be more than a trillion and I don't rule out a \$2 trillion deficit in one of the two fiscal year. I have not read the detail on the Administration's revenue assumptions or how they have accounted for "loans" to the private sector. The government could, of course, make a profit, but as of now, the risk is to the downside on assuming these are "investments" rather than budgetary expenses.

Even should the Administration's forecast prove correct, the rise in budget deficits after 2013, coupled with the fact that the government took on so much debt prior to the peaking of Social Security revenue near 2013, means that more drastic revenue increases and/or spending cuts will have to be legislated.

Inflation: Many observers are worried that inflation is just around the corner. Far from it in my opinion. The two reasons generally cited for expecting inflation are growth in money supply and rising government debt. What most observers don't understand (even after an explanation), is that, from a monetarist point of view, inflation is caused by the growth in mv (money times velocity – money turnover), not just m . Milton Friedman and his followers (and I am trained as a monetarist), believed that V was a stable function of predictable variables. Thus, money supply growth was a proxy for inflation is that if money grew faster than our potential to increase real GDP, inflation would result.

This simple Friedman formula worked fairly well when the U.S. economy was less open and its size dominated the rest of the world. But with increasing trade, floating currencies and the use of derivatives to greatly expand leverage, velocity is no longer stable. Nor is it easy to measure, *ex ante*. What is known is that, in recent years, the rise in asset prices and increased leverage led to much higher-powered money and velocity. And during periods of slack and falling asset equity prices, velocity slowed. Now, however, velocity is likely contracting at a very rapid pace with housing and equity prices falling, deleveraging, and more of that money base being used to support capital requirements. Yet many economists and observers are still using a defunct version of monetary theory, especially on Wall Street.

Bottom line, if money supply is growing by 25%, and velocity is being cut in half over the same period, we are headed for deflation, not inflation.

To date, no one knows whether we are heading into a deflationary or inflationary environment. What we do know is that Fed Chairman Bernanke is as knowledgeable about the situation as anyone. And the Fed is increasing its balance sheet exponentially to insure that the increases in money supply are not overwhelmed by the unknown fall in velocity. To date, there are few signs that enough has been done. So inflation is not a problem.

There could be an inflation problem longer term, but because of intent, not ignorance. I am confident that the Fed will not only know when to slow or reverse the growth in money supply before a nasty inflation occurs, but will also do it. Still, some observers have suggested that the huge increase in government debt to offset the rapid decline in private debt and thus smooth and, hopefully, reverse the economic contraction, will lead the administration, with the Fed's complicity, to reduce the "real" size of the debt by accepting some gradual, scheduled inflation. This is anathema to most free market economists. Still, most also feel that deflation is worse than inflation and that Bernanke's desire to target one to two percent inflation is reasonable.

Can inflation get out of hand? Yes but, near term, deflation is even more likely to get out of hand.

Productivity, profits and wages: Both the stimulus package and the budget have the potential to lower productivity by reallocating resources to less productive uses than market forces would. And as a supply-sider, I agree that lower taxes increase incentives.

Over the past two decades, under both the Clinton and Bush Administrations and during Alan Greenspan's tenure as Fed Chairman, productivity was higher than normal and profits rose impressively. But wages, which rose at a normal pace through the early part of the period, lagged in the most recent expansion. And the tax-rate rises on higher incomes during the Clinton administration do not appear to have hurt the economy since they were coordinated with other measures such as lower rates and a return to budget surpluses. Globalization, the technology boom and higher asset prices were also contributors to muting the tax-rate effect.

In my opinion, recent use of supply-side measures to boost the economy have had a huge social cost. Specifically, the policies of the past administration favored:

- private consumption over private investment,
- incentives over a more fair distribution of income that would foster rather than detract from our national social cohesion, and
- private-sector spending over public investment.

During the period of the past several administrations, our public infrastructure, which supports productivity in the private sector, has deteriorated inordinately as has publically-funded research, health care and education. While many free-market ideologues view any

public expenditure as wasteful, government programs such as the GI bill and the interstate highway system, which were private/public partnerships were quite successful and contributed to productivity.

It is questionable whether other programs such as Medicare and Unemployment Insurance, and Defense add to productivity, although certainly the invention offshoots of, say, Defense have contributed. Thus, a sizeable portion of both the stimulus and budget spending may reallocate resources away from the most productive uses. But that is not to say that they are unwarranted. Rather, these expenditures are simply the result of setting priorities that are not solely intended to increase incentives.

Market impact: The market impact of the stimulus package is mixed. The dire economic situation has resulted in zero risk-free rates and sky-high rates for even moderately risky investments. The stimulus package coupled with Fed and Treasury measures to insure liquidity and rebuild bank capital will bring down the risk premium and, ultimately, raise the risk-free rate. Credit to the most financially-secure businesses, those that are AA and AAA-rated, is flowing again, as are mortgages to high-quality household borrowers. But lending standards are still tightening and it will be months, perhaps years, before any easing of standards reinforces increasing credit potential. If I am correct and the current stimulus does not reverse the downturn, policy rates are likely to stay near zero through 2010. Even the Fed is not forecasting a return to potential growth for several years (although policy rates will likely begin to rise long before the economy reaches its potential).

The dollar is a “wild card”. Economic and banking problems in Europe, and even some concern as to whether the Euro will survive in its present projected form, are helping to maintain the dollar’s value against the Euro. A greater than 12 percent annualized fall in Japanese GDP in the fourth quarter, reversed the rapid appreciation in the yen. Free-floating currencies of countries heavily dependent on exports to the U.S. such as Korea have suffered disproportionately. Even the Canadian dollar, previously supported by the most favorable monetary and fiscal policies in the G7, is suffering from both the proximity of Canada to the U.S. and the rapid downward correction in commodity prices.

Meanwhile countries that manage the value of their currencies have kept them stable during this period. As a result, the Chinese yuan, which was rising on a controlled basis before the economic slowdown, has been stable for the past few months.

Over the longer term, the dollar is likely to fall against some currencies and retain its value against others with problems similar or equally problematic to those of the U.S. The dollar’s value against the Euro is, in my opinion, very uncertain and dependent on political developments such as internal economic pressures on and the cost of maintaining the Euro. It also depends on the relative success of economic policies designed to cure credit and employment problems that are similar to those in the U.S.

Longer term, I favor the Canadian dollar and the Chinese yuan. Canada is a resource rich and politically stable country and Canadian dollar should benefit once the demand for

resources rises back to a level that absorbs excess supply. Canada's banking system is also in much better shape than in the other G7 countries. Their public debt is lower than in other G7 countries and not scheduled to rise as fast as in the U.S. Near-term, however, excess capacity and the cheaper relative cost of oil in the Middle East is keeping a damper on the Canadian dollar. So, too, is the fact that in the 2002-2008 period, the Canadian dollar rose too quickly and undermined the Canadian manufacturing advantage. Canadian businesses are only now adjusting to this development and it will take time for relative Canadian competitiveness to be restored. This can be seen in the fact that the substantial Canadian trade deficit has evaporated. Like the U.S., Canada has an external debt that has to be serviced. Unlike the U.S. Canada has been servicing and lowering their net external debt.

I favor the Chinese currency because the world economy is unlikely to recover unless the growth in Chinese domestic consumption is sufficient to begin to bring the Chinese trade surplus into better balance. As this happens, investors in Chinese will have less excess reserves to "park" in lower-yielding U.S. assets. And as China uses more of the world's commodity resources to support domestic growth and consumption, they will find it more to their advantage to reduce the real cost of those imported resources and capital by allowing the yuan to appreciate.

Equities: Over the past three decades, the ratio of profits to wages has increased. Labor has not shared as much as capital providers in the economic gains that have been made. In the early stages of this shift everyone benefitted since income and capital gains taxes were arguably too high and stifled investment and productivity that contribute to a general rise in per-capita income.

More recently, as the skew to favoring profits and incentives over distributional concerns, was overdone, middle and lower-income households have not shared in the growth as median household income retreated even as mean income increased. In my opinion this, to some degree, contributed to the election result. The standard "lower taxes" mantra of the Republicans gave way to the "Your not getting your share" argument that apparently, along with the recession and focus on very high executive pay, persuaded many "Reagan democrats" to their party.

Whether or not one supports the election outcome, the result is likely to begin a trend where profits decline as a share of National Income. This, coupled with the already debilitating effect of the recession, will likely result in an equity market that is much less robust than in the 1982-to-2007 period. Although the bull market of 2003-2007 did not take equity prices above the early 2000 level, profits increased markedly. The failure of equities to achieve meaningful new highs was due to the unwarranted exuberance that drove prices to unreasonably high levels during the internet bubble.

Near term, equity prices continue to suffer from reduced profit expectations. There is uncertainty as to whether the economic contraction is gaining momentum. Banks have yet to be recapitalized sufficiently to insure adequate lending should demand revive. And

as indicated above, the impact of the stimulus package may only mitigate, not reverse the economic contraction.

In a top-down calculation, David Rosenberg, estimates 2009 and 2010 S&P operating profits to be \$46 and \$55 respectively. Given further write downs and loan loss reserves, he estimates 2009 S&P reported profits to be just \$26. Although risk-free interest rates are likely to remain low for the foreseeable future, risk-adjusted rates are still quite high. Thus PE ratios are likely to remain lower than the norm until the risk premiums move back to more normal levels. If, over the near term, the PE level relative to operating earnings ranges from, say 12 to 15 times 2010 operating earnings (many stocks are already trading below a 10 PE based on reported earnings), the S&P range over the next six months would hover between 660 and 825 (the current S&P level is near 730. It is no wonder, then, that equity prices are falling despite hopes for the future.

I admit that I know neither the actual 2010 profits nor the appropriate PE level (as opposed to the many Wall Street analysts who are constantly paraded before CNBC's audience). Rather I am simply pointing out a range of equity prices that seems consistent with some of the recently accurate economic forecasts such as those of Rosenberg and Nouriel Roubini. Optimistically, assuming that Rosenberg's 2010 profit forecast is correct and that profits further expand to, say, \$62 in 2011 and that the PE range reverts to a more normal 16-18 forward central tendency, it is reasonable to expect the S&P to recover over the next 18-24 months to, say, the 1000 to 1100 range. A rally from whatever becomes the 2009 low would likely begin when investors regain confidence that a recovery will in fact occur. But if the Rosenberg forecast of 3% growth in the second half gives way to slower 2010 growth, any rallies that occur from "oversold" positions in the next few months are likely to be subsequently shown to be of a similar "bear market" type that the S&P exhibited in the late Summer and in December.

The case for investment

I regard the stimulus package as positive in that it reverses the tendency to favor private consumption over much-needed public (community) spending. I also think that the move that begins to redress the imbalance that favored rich over middle and lower income families as desirable. However, these opinions are primarily value and not economic based. And these preferences, shared by the majority if one is to believe the results of the last election, represent a monumental shift from those of the previous administration.

What has not been emphasized enough, in my opinion, either in the election campaign, the Congressional debates or the President's speeches is the need to sacrifice private consumption to make room for more private and public investment. As a country we need to reduce our dependence on foreign capital. We also need to develop the resources necessary to support our future Social Security and Medicare obligations in an environment in which the number of those dependent on these programs increases rapidly relative to the number of workers available to produce the GDP.

In my opinion a consumption tax is the best solution, but that is politically unacceptable. Both right and the left-leaning politicians would combine to reject this solution. The left would claim that such a tax is regressive even though it would be relatively easy to design a tax credit to offset the tax for households below an agreed-upon poverty standard. The right claims it is undo meddling with the private market system and cite the high tax rates in Europe where the value-added tax serves as such a tax. However, the size of the tax and size of the government can be independently determined by the voters. And a shift can be made, as was the case in the most recent election when the public feels that one group has been unfairly favored over another.

The administration clearly understands the need for a relative move to investment from consumption and has designed its budget accordingly. In particular the proposal that businesses set aside a portion of wages for retirement is a positive step (workers would have to opt out of rather than into such a plan). But, the Administration has been too timid in moving in the appropriate direction as is evidenced by the fact that, in the absence of further tax increases or spending cuts, the projected deficit rises in years six to ten. Thus more will be needed, including changes in the Social Security system to take account of the longer work-life to meet future obligations.

In addition to the need to prepare and convince the public that a substantial sacrifice will be needed to return to a sustainable economic course, the administration will also have to reorient incentives away from households and toward business. If the U.S. has any hope of lowering and reversing our trade deficit so as to keep our external debt to a manageable level, over time it must shift consumption relatively toward more exports and less imports. The available ways to do this are:

- protectionism.
- Dollar depreciation,
- Increased competitiveness, and
- Reduced relative growth.

Protectionism is bad because both because retaliation will offset reduced imports by making it harder to export. Dollar depreciation and slower relative growth against China are probably inevitable, so it is important to pressure the Chinese to accept more imports. The administration understands this and is probably already working on this outcome. It is fortuitous that Secretary of State Clinton's first major effort is in Asia and, in particular, China.

Where I am most concerned about the budget, stimulus package and future economic course regards business. The Administration seems unwilling to tackle this need, both because, I fear, they do not accept it ideologically (although President Obama appears open to finding the best economic policies regardless of who proposes them). Perhaps more importantly, it goes against the current public mood. Further, many of those who favor a pro-business solution are the same right-wing spin-doctors that brought about the current problems of inadequate regulation and enforcement, lower lending standards, and a policy leading to gross inequality. Unfortunately, some of the most egregious examples of greed, hubris and incompetence were business leaders.

In uncovering the excesses of business practices, we are in danger of punishing businesses rather than individuals, many who have already abandoned ship with ill-gotten gains. Businesses create most of the jobs that will allow households to improve their income and afford more taxes. Business will produce almost all of our future exports. The administration has already moved to redress the distribution which unfairly favors the rich over others, but it is failing to give enough to businesses to restore incentives in under very difficult circumstance (the banking system is an exception, although there is much to accomplish there as well). Specifically, we need to lower the corporate tax rate to make it more competitive with overseas rates and shift the burden of health care away from business and onto the consuming public. In that regard we also need to broaden the risk pool to allow individual households to purchase care at a reasonable rate.

Finally, a shift from consumption to investment has to be controlled. Any attempt to restrict consumption in the present environment would result in a further contraction and would be counter productive since it would erode business confidence ever faster. Thus, as long as excess resources are available, both consumption and investment should be fostered, giving preference to investment where possible.

Summary

Although the stimulus package is full of warts, many inserted by the Democratic Congress, a huge stimulus package was needed quickly and that task was accomplished. My concern is that the package is insufficient and not targeted enough toward promoting investment relative to consumption. Still the package will mitigate the downturn and buy time to reconsider what is needed to restore healthy growth. And considering the current political environment a package that is 38% tax cuts, 24% investment spending and 38% safety net aid is probably appropriate.

My forecast for the economy is a further 2-3% (4-6% annualized) contraction in the first half followed by a moderate, say 1% (2% annualized) bounce in the second half of 2009. By that time the need for further stimulation will become clear as the unemployment level exceeds 9% and threatens to move above 10% in 2010.

Equities are not, in my opinion, undervalued yet as many forecasters believe. Although the drop has been at the high end of past post WW2 bear markets, the financial crisis and the subsequent economic contraction will be, in my opinion, the worst in that post war period. A recovery in equity prices will anticipate the economic recovery, but it is premature to expect that result presently. Rather, we are likely to see a series of rallies from "oversold" conditions over the next couple more quarters. I do not rule out a S&P move toward the 600 level, although it seems to me that on an individual basis, many stocks, e.g. GE and Pfizer (soon to be downgraded from AAA to AA or lower), now anticipate at least as unfavorable environment as I predict. Nevertheless, just as stocks were wildly overvalued from 1998 into early 2000, prices may become undervalued relative to prospects.

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March 2, 2009