

The Economy and Market Can Rise, Despite Government Mistakes

How many mistakes can government make? It isn't a trick question, or an overtly political one. Nor is it philosophical; as in "how many angels can dance on the head of a pin?" It's a real and consequential question.

And the answer seems to be an endless number. It seems to us that many of these mistakes began when the Bush Administration and a Republican Congress started spending money like drunken sailors. Total federal spending rose from 18.4% of GDP in 2000 to 20.7% of GDP in 2008.

Every extra percentage point of GDP taken from the private sector by government reduces potential real GDP growth by up to 0.2%. A reduction in potential real GDP increases the natural rate of unemployment and undermines asset values. This creates economic problems and increases anxiety, which in turn brings calls for more government intervention.

In April 2008, these fears were addressed by a bipartisan \$350 billion stimulus plan. This grew the government even more, creating more problems. Then, the Bush Treasury let Lehman Brothers fail, creating financial market chaos. It then proposed a \$700 billion bank bailout plan (TARP) *without* allowing any relief from fair value accounting rules.

The result was a collapse in the velocity of money and the worst decline in real GDP since the early 1980s.

In January, only 9.6 million autos and light trucks (SUVs, minivans, pick-ups) were sold in the US. At that rate, it would take 25 years to replace the 240 million vehicles on American roads. For the past decade, retail sales excluding autos have averaged about 30.2% of personal income. In December, they fell to 28.1%, the lowest on record. These are amazingly bad numbers.

In response, fear increased and the new Obama team accelerated the pace of government interference. Tomorrow we may get a proposal for another \$1 trillion to help remove toxic assets from bank balance sheets, but apparently no relief from mark-to-market accounting.

At the same time, a \$790 billion stimulus bill passed Congress last week, but last minute additions to the bill contain draconian and truly anti-capitalist limits on executive pay for banks that take TARP money. The healthiest banks will pay back TARP and some new banks will refuse it, while struggling banks will be hurt. To understand this, imagine what would happen to professional baseball teams that were forced to limit pay for their top players to a fraction of the going rate.

In the end, the economy will pay a large price for these mistakes in government policy. Potential real GDP will be lower than it would be otherwise and unemployment will be higher. That's the message of the stock market, today, and in the past week. Every time an absolutely essential government proposal is passed, or an important economic speech is given, the market heads lower.

Nonetheless, because the Federal Reserve has pumped an incredible amount of liquidity into the economy, we expect the economy to recover – despite government policy mistakes, and we expect rising equity values.

After all, the government was making similar mistakes in the late 1960s and 1970s, but after a 30% decline in the S&P 500 in 1974, it rallied 32% in 1975 anyway. This was because of easy Fed policy. It masked the damage to long-run wealth creation, much like we expect in the year ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-17 / 7:30 am	Empire State Mfg Index - Feb	-23.8	-20.0	-34.65	-22.2
2-18 / 7:30 am	Housing Starts - Jan	0.530 Mil	0.520 Mil		0.550 Mil
7:30 am	Import Prices - Jan	-1.3%	-1.9%		-4.2%
7:30 am	Export Prices - Jan	-1.0%	-0.9%		-2.3%
8:15 am	Industrial Production - Jan	-1.5%	-1.4%		-2.0%
8:15 am	Capacity Utilization - Jan	72.4%	72.4%		73.6%
2-19 / 7:30 am	PPI - Jan	+0.3%	+0.1%		-1.9%
7:30 am	"Core" PPI - Jan	+0.1%	+0.1%		+0.2%
7:30 am	Initial Claims - Feb 14	620K	621K		623K
9:00 am	Philly Fed Survey - Feb	-25.0	-21.4		-24.3
9:00 am	Leading Indicators - Jan	0.0%	0.0%		+0.3%
2-20 / 7:30 am	CPI - Jan	+0.3%	+0.1%		-0.7%
7:30 am	"Core" CPI - Jan	+0.1%	+0.1%		+0.0%