October 3, 2012

Captain Hook came to mind recently. More specifically, the alligator that swallowed the clock has been on my mind. While I go along with the job of mapping out investment plans, I keep hearing this tick-tock; sometimes soft, sometimes loud. What is the tick-tock, and will the alligator ever strike.

The markets are functioning and recovering, the economy is growing, albeit slowly, companies as a whole are adding some jobs, and consumers are spending. There are, however, two issues that bother me. The current world of positive economic growth and market growth can continue until one or both of these issues become a problem. Let's call these problems Tick and Tock. I can hear the alligator, but I don't know when it will strike. When it does, I don't know how bad the bite will be. These two problems will not go away on their own, and we will not be out of the woods until they are resolved. Unfortunately, we do not know even what resolution looks like because we have not been in this position before.

I will begin this letter with a discussion on prices. Prices have always been around. They tell us how much of one good we need to trade for another good. If there is something we want, prices will clearly tell us how much it will cost us. We might not like the answer, but we will know. Changes in prices convey information. If we pay attention to these changes, we can learn something. That 'something' might be good or it might be bad.

When prices change, it can have a real impact on our lives, directly and indirectly. People react to change. Health care price changes can lead to policy changes in how health care is delivered and the quality of that care. Food price changes can lead to starvation and rioting in the case of rising prices, or a better diet and health with lower prices.

When we make decisions on what we decide to do with the money we collect for a later day, prices can influence our decisions. For example, we recognize that we experience inflation, and therefore we would like our capital to keep up with inflation. We want to invest in things that will increase in price.

The price we pay today for something indicates the likelihood of that asset experiencing further price increases. If you purchased General Electric stock in 2000 at 39 times earnings, your chances of experiencing additional price increases were slim. You are still waiting 13 years later. Prices matter.

Price changes can convey information and they do so quickly and efficiently. Assume that there is an earthquake in your town and the price of food staples jump. A loaf of bread is now $10 per loaf and milk is $20 per gallon. Is this profiteering? Is it a bad thing? What information does it convey? It could convey that there is a significant change in the future supply of bread. Future supply could be greatly restricted due to the earthquake damage, and the time it will take for any new bread to be delivered.

In this case, there is both a new demand and a new supply. Demand has increased and supply has decreased. If prices are maintained at previous levels, what would happen? If you live in a town where it snows, what happens in your local grocery store after the first forecast for snow? There is a run on milk and bread. Has supply really changed here? Stores do not dramatically raise their prices, because they realize that supply, while perhaps delayed for a few hours, has not really changed. Customers can rush to the store and stock up 'just in case'.

When supply is really impacted after a disaster, price increases can temper this panic driven increased demand, and can keep people from hoarding available supply. They will be forced by the higher prices to buy an amount closer to their actual need. The price increases serve a public good in this case.

If the government prohibited the price increase, there would be hoarding by the first comers and less distribution of the scarce resource. Rules limiting purchases would not work, because there would not be enough people to enforce such rules. By comparison, market driven price changes are quick and efficient in conveying information and causing a change in behavior.

I have brought this up to make the point that prices changes are relevant, important and impact our lives. Prices changes can be a result of supply and demand changes that naturally occur, or they can be a result of manipulation or government edict. If prices can change behavior, and the government wants to change our behavior, might they use prices changes to do so? Is this efficient?

Consider again the example of an earthquake. Before the event, resources were allocated in an efficient manner during a period of calm. I referred to the price changes as being quick and efficient: Quick in communicating information and efficient in altering behavior in the new environment. I did not suggest that the new environment was always better. The new situation might be one where everyone is worse off for a period of time. This is not hard to imagine after an earthquake. The new reality, which might not last forever, would have us spend our money in ways that we would not choose to do so prior to the earthquake. This new spending pattern would lead to a different result than if there had been no earthquake.

When a monopoly manipulates prices, we view that as a bad thing because our resources will be allocated in a less than ideal way. We will probably have to pay more for the monopolist's products, and have less to spend on other products. Historically, our country has preferred competition, so that one organization does not have control over pricing.

What happens when the Government is the monopolist and begins manipulating prices. Is the new environment better than before? Do resources get allocated as efficiently as they could? Do these manufactured price changes lead to a change in behavior? What happens when the manipulation ends?

These are all good and relevant questions to consider today. Why? Because the Government has been manipulating the price of a good that each of us uses every day, and doing so in a significant way. What is this good? It is money. The price of money is being manipulated. This manipulation will not last forever, and we need to think about what will happen when it ends. This is one of the two issues that I worry about. This is the Tick. So what is the Tock?

I suppose it would be appropriate for the Tock to be related to the Tick, and it is. The Tock is the inability of our politicians to deal with our debt and deficit seriously. Europe has a challenging situation also, but it has 17 different governments that need to coordinate on a plan. We have one.

I don't know why it is so hard for our elected leaders to deal with accounting and economic issues, or to recognize the seriousness of these issues. Consider this:
The combined revenue in the last fiscal year of Apple, Exxon, IBM and Proctor & Gamble was $783 billion. Think for a moment about the discipline that these companies deploy each year to manage that revenue stream and decide how it gets allocated across investments. Now consider the qualifications of the people who put together the stimulus bill. Over $800 billion of spending, prioritized and put together by whom? Were these people as disciplined and informed as the management teams of Apple, Exxon, IBM and Proctor & Gamble? Should they be?

We have spent over $10 Trillion dollars, yes trillion, in the last three years without actually passing a budget to do so. Sure, there have been proposed budgets and continuing resolutions, but nobody seems to want to approve such egregious spending by signing off on it. This is a problem.

Ben Bernanke and the Federal Reserve are the owners of the Tick. The Federal Reserve, in keeping short term interest rates at close to zero and purchasing trillions of longer term bonds, have undertaken monetary policies well beyond what has been done in the past. Chairman Bernanke has stated publicly and to Congress directly over the past few years that Fed action was not sufficient to address our problems. Congress needed to act as well. They have not done so, and so the Fed has been alone in trying to do what it can, and subsequently has taken us into unexplored territory. We have not been here before, so we really do not know what will happen as a result of our actions.

Again, I do not know how these two issues, Tick and Tock, will resolve themselves. One thing I do think about is how the price changes affected by the Fed have changed behavior, and what the ramifications of this might be. Have investors been buying securities that they never would have considered before as they stretch for yield? How will certain investments react to higher interest rates? How will all investments react to higher rates?

The challenge for preparing for the Tick and Tock is that the market can ignore problems for years before deciding that they are important. We do not know when or how these issues will ultimately be resolved. We do know that they are out there, and we look for signals that danger is approaching. While the markets are behaving, however, there are returns to be generated.

The problems are significant, but the potential of America is also significant if we can tap into the good. Please feel free to call with any questions.

Sincerely,

Peter B. Harre, CFA