

The World According to TARP ... and Jack London

In 1978, John Irving published *The World According to Garp*, a novel about anxiety. In a scene from the 1982 movie adaptation of the novel (screenplay by Steve Teisch), Garp is house hunting with his wife and a realtor. As they view one house, a small plane crashes into it and Garp exclaims, “We’ll take the house. Honey, the chances of another plane hitting this house are astronomical. It’s been pre-disastered. We’re going to be safe here.”

In the recent financial crisis, investing was about anxiety. The 2007-09 bear market was the worst since the Great Depression. The subsequent market advance continues, however, aided in large part by the ministrations of the Federal Reserve and Treasury Department. In a stunning reversal of sentiment over the past year, many investors now seem to mimic Garp after the plane crash, thinking that the recent bear market means we are “pre-disastered,” that nothing more can go wrong.

More sober investors, glass-half-empty types, cannot see past the plane crash. The fundamentals of the U.S. economy look terrible –to take one of many depressing numbers, for the year ended September 30, earnings for the Standard & Poor’s 500 index of large companies fell 83 percent. Amazingly enough, this actually is an improvement from the rate of decline during the first two quarters this year. To put this in perspective, annualized earnings have rarely fallen even as much as 25 percent. When they have, the stock market has declined at a rate of 25 percent annually. Clearly, we have substantial evidence of the disaster ~ of an economy in distress.

The more optimistic investors, glass-half-full Garp types, argue that such statistics are just history, an admittedly depressing reality that the stock market already discounted in the severe decline ended last March. Investing based upon economic headlines is like trying to drive a car while looking through the rearview mirror. One thing we can know with certainty is that policymakers are not ignoring or overlooking the dismal economy. We are living now in a world according to TARP, in which Federal Reserve and Treasury are shoveling liquidity into the economy and financial markets. Congress is discussing follow-on stimulus bills. Political polls indicate voters place the economy as their top concern, overshadowing healthcare and other headline issues. Politicians are unlikely to ignore these consistent polling trends.

The question is not whether government policy is oriented towards improving the economy, but whether it will make a difference. Changing our literary genre, think of the economy as if Treasury Secretary Tim Geithner and Fed Chairman Ben Bernanke are characters in a Jack London story, trying to start a fire in a soggy arctic forest. They have dry newspaper, slightly damp kindling and a wet log. When lit, the newspaper always nicely erupts into flame. The kindling, after a slow start, also catches fire and provides a burst of heat and light. It all ends quickly, though, if it is not enough to get the log burning.

“...there was about him a suggestion of lurking ferocity, as though the Wild still lingered in him”

- Jack London, White Fang

The paper that allows our heroes to get the flames started is liquidity created by the Federal Reserve and Treasury as emergency responses to the financial meltdown. Some statistics demonstrate an almost immediate response to the paper stage – for example, the quick uptick in car sales because of the “Cash for Clunkers” program. The kindling is the

economy’s inventory cycle – firms have to restock inventory once the surge of liquidity leads to a quick burst in sales. The most recent data also shows the start of an inventory rebuild – so the kindling is providing a nice flame. The log, however, is the “real” economy, still wet from the balance sheet destruction of the financial crisis. Geithner and Bernanke may be on hands and knees blowing on the small flames, but until there is substantial business investment in anticipation of economic improvement, until consumers finish rebuilding their balance sheets and start spending again, that warm fire is unlikely to last long. As with *White Fang*, Jack London’s wolf-dog hybrid character, the recent benign auto purchase and inventory statistics, induced by government stimulus, may mask a lurking ferocity of potential troubles, the lingering wildness of the excesses of the banking and real estate bubble.

Lightning may very well strike twice in the same place if the place is a tall metal pole in a high, open field. Count us as skeptics of the Garp “pre-disastered” point of view that the mere existence of extensive troubles in 2008 insulates us from problems in 2010. We do not believe a sharp market decline necessarily is near – as we write this, our typical account is overweight equities, based upon our (nervous) appraisal of the strength of the current market. To quote Jack London again, “Life is not a matter of holding good cards, but sometimes, playing a poor hand well.” The problems in the economy are legion, but beyond our control. The economy and financial markets have dealt us a poor hand, and our efforts now are devoted to playing it well.