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### **Eye on the Market, June 14, 2011 (attached PDF is easier to read)**

**Market update:** for better or worse, this is the kind of year we were expecting. We were surprised at the market's unbridled optimism in April\*, since the tug-of-war between private sector profits and public sector problems has a long way to go. We chose the charts on the front page of our 2011 Outlook carefully; they were designed to show that equity markets were priced inexpensively, but were likely to stay that way, given too much stimulus in the East, and ineffective stimulus in the West \*\*. We expect a modest second half recovery, based primarily on US capital spending increases, easy credit conditions everywhere, and a pick-up in industrial production in Japan. But the world's structural problems are weighing on the private sector, and our portfolios are positioned for a single-digit year in credit, equities and hedge funds.

\* The Osama Bin Laden episode marked the equity market peak. Some commentators saw this event as a basis for further optimism, but unsurprisingly, the positive glow lasted for only around 2.5 hours the subsequent Monday. According to the Congressional Research Service, **over the last decade, the US has spent at least \$1.1 trillion in war funding operations, surpassing the constant-dollar cost of the Korean and Vietnam Wars combined.** This highlights the disproportionately large pain that small, non-sovereign entities can inflict in the modern era.

\*\* So far, the large growth and employment multipliers from deficit spending estimated by Christina Romer (former Chair of the President's Council of Economic Advisers) have not materialized. John Taylor and John Cogan from Stanford have been closer to the mark: an initial boost, but then a rapidly fading benefit

**Something different this week.** I was on the road seeing clients last week, and was asked "*what should be done about job growth*". We are investors and not politicians, so my ideas [a] are not relevant. However, it seems to me that **anyone involved in the jobs debate should be required to read the article below, written after the prior deep US recession (1990-1991).** It's from George McGovern, one of the most liberal politicians [b] ever to hold office and run for President. His epiphanies after leaving office and running the Stratford Inn are worth considering as legislators contemplate additional job creation measures, and the broader regulatory environment in which the private sector operates.

#### **"A Politician's Dream Is a Businessman's Nightmare", by George McGovern, June 1992 [c]**

*Wisdom too often never comes, and so one ought not to reject it merely because it comes late.* (Justice Felix Frankfurter). It's been 11 years since I left the U.S. Senate, after serving 24 years in high public office. After leaving a career in politics, I devoted much of my time to public lectures that took me into every state in the union and much of Europe, Asia, the Middle East and Latin America.

In 1988, I invested most of the earnings from this lecture circuit acquiring the leasehold on Connecticut's Stratford Inn. Hotels, inns and restaurants have always held a special fascination for me. The Stratford Inn promised the realization of a longtime dream to own a combination hotel, restaurant and public conference facility--complete with an experienced manager and staff. In retrospect, I wish I had known more about the hazards and difficulties of such a business, especially during a recession of the kind that hit New England just as I was acquiring the inn's 43-year leasehold. **I also wish that during the years I was in public office, I had had this firsthand experience about the difficulties business people face every day. That knowledge would have made me a better U.S. senator and a more understanding presidential contender.**

Today we are much closer to a general acknowledgment that government must encourage business to expand and grow. Bill Clinton, Paul Tsongas, Bob Kerrey and others have, I believe, **changed the debate of our party [d].** We intuitively know that **to create job opportunities we need entrepreneurs who will risk their capital against an expected payoff.** Too often, however, public policy does not consider whether we are **choking off those opportunities.**

My own business perspective has been limited to that small hotel and restaurant in Stratford, Conn., with an especially difficult lease and a severe recession. But my business associates and I also lived with federal, state and local rules that were all passed with the objective of helping employees, protecting the environment, raising tax dollars for schools, protecting our customers from fire hazards, etc. While I never doubted the worthiness of any of these goals, the concept that most often eludes legislators is: 'Can we make consumers pay the higher prices for the increased operating costs that accompany public regulation and government reporting requirements with reams of red tape.' **It is a simple concern that is nonetheless often ignored by legislators [e].** For example, the papers today are filled with stories about businesses dropping health coverage for employees. We provided a substantial package for our staff at the Stratford Inn. However, were we operating today, those costs would exceed \$150,000 a year for health care on top of salaries and other benefits. There would have been no reasonable way for us to absorb or pass on these costs.

Some of the escalation in the cost of health care is attributed to patients suing doctors. While one cannot assess the merit of all these claims, I've also witnessed firsthand the explosion in blame-shifting and scapegoating for every negative experience in life. Today, despite bankruptcy, we are still dealing with litigation from individuals who fell in or near our restaurant. Despite these injuries, not every misstep is the fault of someone else. Not every such incident should be viewed as a lawsuit instead of an unfortunate accident. **And while the business owner may prevail in the end, the endless exposure to frivolous claims and high legal fees is frightening.**

Our Connecticut hotel, along with many others, went bankrupt for a variety of reasons, the general economy in the Northeast being a significant cause. But that reason masks the variety of other challenges we faced that drive operating costs and financing charges beyond what a small business can handle. It is clear that some businesses have products that can be priced at almost any level. The price of raw materials (e.g., steel and glass) and life-saving drugs and medical care are not easily substituted by consumers. It is only competition or antitrust that tempers price increases. Consumers may delay purchases, but they have little choice when faced with higher prices. In services, however, consumers do have a choice when faced with higher prices. You may have to stay in a hotel while on vacation, but you can stay fewer days. You can eat in restaurants fewer times per month, or forgo a number of services from car washes to shoeshines. Every such decision eventually results in job losses for someone. And often these are the people without the skills to help themselves--the people I've spent a lifetime trying to help.

In short, "one-size-fits-all" rules for business ignore the reality of the market place. And setting thresholds for regulatory guidelines at artificial levels--e.g., 50 employees or more, \$500,000 in sales--takes no account of other realities, such as profit margins, labor intensive vs. capital intensive businesses, and local market economics. The problem we face as legislators is: **Where do we set the bar so that it is not too high to clear? I don't have the answer. I do know that we need to start raising these questions more often.**

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**So, there you have it, one of the more remarkable epiphanies in American politics: a paean to entrepreneurship and government restraint from one of its most progressive members.** Public epiphanies like this are rare, but there have been others. Last year, Al Gore conceded that first-generation ethanol was "not good policy" given its low energy conversion ratios, and said he had supported ethanol out of "a certain fondness for the farmers in the state of Iowa because I was about to run for president" [f]. In 2008, former Fed Chair Greenspan conceded that his Ayn Rand philosophies regarding regulations and shareholder self-interest were flawed. Perhaps the most famous epiphany was from Robert McNamara, Secretary of Defense and one of the principal architects of the Vietnam War. In 1995, he conceded that he was "wrong, terribly wrong" about the war. George McGovern was one of the war's fiercest opponents, saying on the floor of the Senate, "I'm tired of old men dreaming up wars for young men to fight".

There may be no magic elixir of policies to speed the adjustment the US faces. Look at it this way: the US is trying the mega-stimulus route, while the UK has accelerated its fiscal austerity program. Yet both countries are struggling with below-trend growth and employment. Perhaps after a debt binge, there are no easy answers, other than time. What to do next? McGovern's article suggests that an overly interventionist public sector may be the wrong answer, given the unintended consequences.

Michael Cembalest  
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Notes

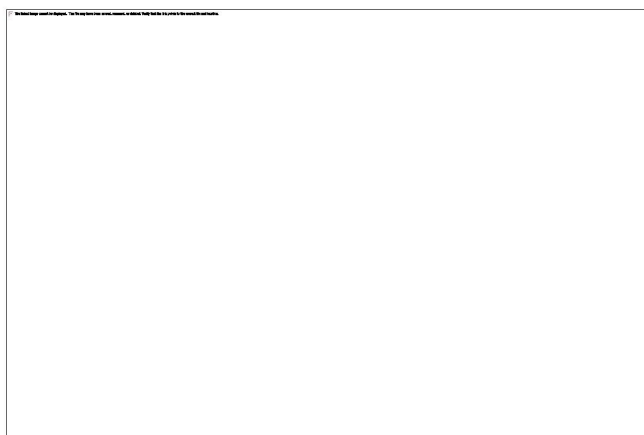
[a] I like the idea of **extending the holding period for short term capital gains to 3-5 years, and cutting the long term capital gains rate closer to 5%-10%**. It could encourage more business formation, since more of what people create, they keep. If the cutoff year is properly set, it could be done on a deficit-neutral basis.

[b] According to methodology described by Keith Poole of the University of San Diego in the *American Journal of Political Science*, **McGovern ranks as the 99<sup>th</sup> most liberal politician out of 3,320** politicians serving from 1937 to 2002.

[c] In a letter to the Wall Street Journal. Reprinted with permission; emphasis added.

[d] This may not have been a permanent change. The National Taxpayers Union rated the Blue Dog Democrats as having a fiscal conservatism score of 52% in 1995; by 2009, it had fallen to 18%.

[e] Would McGovern's focus on red tape make sense today? **According to surveys conducted by the National Federation of Small Business, the answer would be yes.** The 3 issues most frequently mentioned as each respondent's "single most important problem" are Poor Sales, Regulation & Red Tape, and Taxes. Two things of note. First, Regulation & Red Tape concerns have been steadily rising over the last two years. Secondly, availability of credit does not show up as an issue. As the NFIB wrote in May 2011, "92 percent reported that all their credit needs were met or that they were not interested in borrowing. Eight percent reported that not all of their credit needs were satisfied. Three percent reported financing as their #1 business problem, so credit supply is not a problem for the overwhelming majority."



[f] As reported by Reuters, Gerald Wynn, November 22, 2010.

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