Financial Capital and Political Capital

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This past quarter was full of sound and fury, signifying something, but in my opinion, something less than we have been led to fear. The quarter began with the debate over the US debt ceiling that appeared to nearly plunge the U.S. into default. This controversy was a major factor in S&P's decision to downgrade the US's venerable sovereign rating to AA+. The fear this debate generated may have contributed to a slowing of economic growth.

At the same time, it became apparent that there would be a significant risk that the Euro might collapse if Germany decides not to support the EU peripheral countries that are too heavily in debt and now trying to shrink their large social spending. While I do not think this will happen because I believe it is not in the interest of any of the participants, the possibility of this colossal failure of political and financial capital caused the markets to price in a substantial, global recession.

From July 25th to August 8th the S&P 500 dropped 17%. From that August low until this writing the volatility in all markets has been as high as it was in 2008, or any other time in our history. The CBOE volatility index, also known as the VIX rose above 40 for 3 months. This has happened on 2 other occasions in the last 20 years.

In a televised interview on CNBC in early October, Allen Greenspan said that the risk premium on the stock market is as high as it was in the '30s. In other words, the stock market is once again discounting a depression that I do not believe will happen. The fear of a European bank crisis and the worldwide effect of that fear have sent stock prices far below what I consider fair value.

"The Real Economy" Shows Cautious Growth

Outside of the absurd theaters of finance and politics, in a place sometimes referred to as "the real economy," corporate America continued to grow. Revenues, profits and cash generally rose and debt declined. Although this growth is not as strong as most recoveries in the past, the reaction to it is, to put it mildly, inappropriate. Markets panicked while corporate America chugged along. What is going on here?

The financial and political worlds have always been linked since before Barclays began selling bonds to finance the British Empire in the 18th Century. The debate over the role that the government should play in the private economy and the degree to which it should play it are at least as old.

In the world of finance, we use the term "capital" virtually interchangeably with the term "equity." The bank's capital is what is left after its assets or loans are sold and its debts or deposits are paid off. In normal times, we do not think of banks as having to be liquidated. Accordingly, we merely look at how much capital stands behind the loans they make. Of course, in a panic, people cash in their deposits. At such times, runs on the bank can threaten its ability to operate. Thus, if people lose confidence in the banks, perception can become reality. This was our sorry condition both in the Great Depression of the 1930s and the Great Recession of 2008. Now a similar fear has gripped Europe.

The Struggle Between Political and Economic Capital…

Perception and confidence are among the most important elements of political capital. Pundits often use the term "political capital" in a negative sense when a politician has "invested" in something that the public rejects. The buildup of confidence and trust can take considerable time in much the same way as advertising builds a brand, but for a considerably more significant purpose. For example, Winston Churchill was building political capital from '29 to '39 while he railed against Nazism. Yet he was ignored until the invasion of Poland made the accuracy of his predictions clear. Unlike a bank his political capital was ignored until it was needed.

Today, and for the past several years, we are keenly aware of the tension that exists in every major country between the promises its government has made to citizens and the ability of each government to deliver on those promises. Politicians may paint their solutions to these problems in stark contrast to each other, but ultimately the issue is slower than expected growth which makes all of these problems more difficult to solve.

…Affects Emerging as Well as Developed Economies

While we see this clearly in the US and Europe, we should not forget that China and Brazil, the two largest developing nations, are also struggling with the problems of inflation and incomes. In these nations, just as in the developed world, the intersection of government with the banking system is still the mechanism whereby frustrations play out. The Chinese fear social unrest if they allow the currency to rise against the dollar. Similarly, interest rates in Brazil are very high. As a result, the Brazilian government is attempting to restrict capital inflows so that they do not destroy the nation's ability to export.

Although we may envy the 8% and 9% annual growth rates of GDP in both nations, their stock markets fell as rapidly as ours. They are still valued at higher PE ratios than they have been in recent years, whereas our market is much cheaper than it has been relative to recent history.

Pippa Malgren's Vision of Long-Term Trends

One explanation for the slower US economic growth that has received no publicity, but which I believe merits attention, was offered by the international consultant Dr. Pippa Malgren of Principalis Asset Management this past April at the CFA Institute's annual conference in Edinburgh. Her thesis is that, from the fall of the Berlin wall in '89 until about 2007, the world enjoyed above average growth rates because of the vast, under-utilized assets that were unlocked with the death of Communism. As what had formerly been the Communist hegemony played "catch up" to the rest of us, the entire world benefited.

Now, however, we are dealing with the effects of those large numbers of people who have assimilated into capitalist society and now want all the same things we have. One could argue that the persistence of low interest rates that fueled the housing bubble was caused by the Chinese buying our bonds and driving interest rates down. Following that bond splurge was the so-called "super spike" in oil prices that ended in July of '08. I certainly think that both events were significant contributors to the recession that we now blame solely on the financial crisis and its corollary, the implosion in mortgages and the housing industry.

Because Dr. Malgren's analysis of the events of the last two years does not fit neatly into any political policy prescription, it has received no media attention. Mind you, I do not regard it as the sole and overriding explanation of these events. I do think, however, that it demonstrates the complexity of recent political and economic affairs in a way that investors must consider dispassionately if we are to make the best decisions we can under today's circumstances.

The Only Thing We Have To Fear…Guess What It Still Is

Many long-term investors have been sorely tested by the recent market action and the media barrage in which everyone seems to have a different theory but one conclusion: that everyone who disagrees with the pundit making the call is wrong and stupid. I believe this popular and simplistic opinion is a reason by itself to own good stocks for the long run. I think the current fear is exaggerated. This is not 2008. Fears of a double-dip recession are overstated. Auto sales, rail car shipments and the Baltic Dry Index of ocean-borne freight all show signs of life that do not forecast recession.

Earnings are solid, even if the economy is underwhelming. Earnings haircuts for a "normal" recession have already been included in stock prices. US companies have less European exposure than feared. And most important, especially as we approach the election year of 2012, nearly every media source is politicizing investment decisions. With emotions so high, and growing more feverish with every debate, I consider it more important than ever to divorce your investments from your political beliefs.

Conclusion

Across the world, some form of democratic capitalism has taken hold; but the marketplace of politics and the world's capital markets still continue to struggle. As a result of this ongoing problem, I believe that common stocks are an uncommon value and that those who hold them or buy more now may be well rewarded over the next few years.

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