Chapter 1

Getting the Right Perspective

Many people are calling the recession and financial crisis of 2007–2009—what this book will call the Panic of 2008—the worst economic calamity since the Great Depression. With the unemployment rate near 10 percent, financial institutions taking massive losses, and the government spending trillions of dollars, there is plenty of pain and fear to go around.

It's understandable that so many feel the world as we know it is coming to an end. But the Great Depression experienced an average unemployment rate of 19 percent for a decade (1931–1940) and a string of four years with the jobless rate above 20 percent (1932–1935). Today, the economy is not even close to that type of collapse. About the only thing that really does resemble the 1930s is how politicians and political pundits are using the crisis to gain political advantage.

Probably the most egregious example of this was Paul Krugman's *New York Times* column from May 31, 2009, "Reagan Did It."[1] In his column, he said that the Garn–St. Germain Depository Institutions Act, signed into law by Ronald Reagan way back in 1982, was the "key wrong turn—the turn that made [the current] crisis inevitable."

Krugman claimed that Garn–St. Germain turned "modest sized troubles of savings-and-loan institutions into an utter catastrophe." He tied this to today's crisis by arguing that rising consumer debt levels were "made possible by financial deregulation." Thus, in one fell swoop, he blamed just about everything that has gone wrong in the past 30 years on Ronald Regan.

This is all absolutely absurd. First, Garn–St. Germain—legislation that provided much-needed regulatory relief to savings and loans (S&Ls)—was passed by an overwhelming majority in a Democratically controlled House, 272–91. Then the Senate passed the legislation by voice vote—it was supported so widely that there was no need to count votes.

In the 1970s, S&Ls had their hands tied by three major regulations. First, the interest rates they could pay to depositors were capped at 5½ percent. Second, the only loans they were allowed to make were 30-year fixed-rate mortgages—no adjustable-rate mortgages and no other types of loans. Third, their business was geographically isolated—S&Ls were only allowed to make mortgage loans within a 50-mile radius of their home office.

These regulations set the S&L industry up for collapse. As inflationary monetary policy in the 1970s lifted interest rates above the government's artificial cap, the S&Ls lost depositors to money market funds. The S&Ls then sold certificates of deposit to the money market funds, which meant they were paying market rates to the defecting depositors anyway. At the same time, in the 1970s, many mortgages were assumable, meaning a seller could transfer his mortgage (with the same outstanding loan amount and interest rate) to a buyer. This meant that S&Ls were paying higher rates for deposits than they were earning on loans. In 1982, before Garn–St. Germain was even passed, the S&L industry had a tangible net worth of basically zero.[2]

When Paul Volcker raised short-term rates above 20 percent in the early 1980s, the banking and S&L crisis exploded into an even bigger problem. To blame all this on deregulation, as Krugman does, is simply misdirection. It was not deregulation that caused financial problems, but mistakes in monetary policy that drove inflation and interest rates up, and nanny-state regulation that made it impossible for S&Ls to defend themselves against the economic environment. The banking crisis of the 1980s is a perfect example of government failure, not market failure. And, for that matter, so is the Panic of 2008.

The attempt by Paul Krugman to shift blame to deregulation, and then in a gratuitous fashion to Ronald Reagan, is sleight of hand. But there is a method in his madness. If he and other supporters of big-brother government can convince everyone that capitalism and free markets led to the crisis, then they can rally support for growth in government, which is what they have always wanted.

Intellectually speaking, this attempt at misdirection—at blaming capitalism—is really quite daring. If we apply the logic of the left to airplanes, you can see how ridiculous it is. Airplanes fly partly because wind flowing over and around the wing generates lift. The science behind this dynamic was discovered by Daniel Bernoulli; but when planes crash, no one questions the science of fluid dynamics.

Capitalism is also a natural force. It is an organic method of arranging the economy that has proven itself over centuries. To argue that economic problems occurred because capitalism failed is the equivalent of saying that a plane crashed because Bernoulli's principle doesn't work anymore. But that, of course, can't be true. Capitalism did not fail—it never fails.

The current crisis, just like the Great Depression and the stagflation of the 1970s, has its roots in government policy mistakes. While we all wish the crisis had not happened at all, seeing it as government failure—not market failure—should give us hope for the future. The future looks much brighter than the pouting pundits of pessimism would have you believe.

Fear and Anger Are Understandable

Certainly, some of the most venerable names in U.S. business failed and the stock market was down nearly 60 percent from peak to trough. The housing market collapsed, and the unemployment rate rose to its highest level in 26 years. The government is running budget deficits in the trillions of dollars and is taking over financial firms and auto companies, all the while making very noisy plans to redistribute more and more wealth.

With retirement savings decimated and jobs and houses lost, fear and anger are understandable. Many people just want someone to blame. And there seems to be plenty to go around. So just what is there to be optimistic about?

In my view, a great deal. We are alive during a period of unbelievable technological progress. The combination of technology and entrepreneurship is pushing toward great new inventions right now, as it has for hundreds of years. Productivity is booming, the potential of the Internet has barely been realized, new drugs and medical equipment are being worked on at a frenetic pace, energy research is accelerating (even without government subsidies), and the list goes on and on.

Think about your hobbies—golf, tennis, biking, photography, or model trains. No matter where you turn, new technology is changing everything—for the better. And all of this is lifting living standards and wealth to new heights.

What people think are stumbling blocks are less important than they seem. Human beings have confronted mountain ranges, oceans, pandemics, jungles, panics, depressions, and world wars, yet here we stand. Despite some very serious economic trouble, and many forecasts that the end had come, wealth has continued to expand for 200-plus years. So why *shouldn't* we be optimistic—things have been getting better for a long time, and this is unlikely to change right here and right now.

Just so you don't think I'm crazy, there *are* things that people should worry about. The U.S. economy will pay a long-term price if the government continues to interfere in the marketplace. Capitalism is still the best—and only—way to create long-term increases in wealth, and the more the government moves to redistribute income in a socialist fashion, the more our economic growth could suffer.

But, as of right now, the potential damage from government action has been priced into the market. For at least the next year, probably two, the stock market and the economy will surprise many as they remain resilient and robust in the face of a potential negative drift in government policy. This has happened before, in 1934–1937 and then again in 1975–1976, when the stock market did well despite a negative drift in government policy during these periods.

While many conservatives are terrified about the current populist drift in economic policy, the United States not only survived the 1930s and 1970s, it prospered in the years that followed. Moreover, there were companies and investment strategies that did well in both the 1930s and the 1970s. The United States is a very resilient country.

In order to understand this optimism, it is important to look back at what caused the so-called crisis we have just lived through. It's not what the conventional wisdom tells you. And understanding why the conventional wisdom is wrong is the most important step in overcoming the near brainwashing that our popular press and political class have provided over the past few years.

To be absolutely, 100 percent clear, I do not believe that greed, capitalism, high levels of debt, subprime loans, credit default swaps, derivatives, criminal activity, or leverage were the root problems that caused the Panic of 2008. They may have generated a great deal of fear once the panic started, and they were definitely at the center of the story, but they did not cause the panic.

The United States (and the world) did not experience a failure of capitalism. Nor was it a "failure of finance," as *The Economist* magazine called it.[3] We did not replay the Great Depression, and it wasn't the end of the world. American economic history is filled with economic shocks that were larger and more dangerous than the Panic of 2008.

It was government policy mistakes that pushed the economy to the edge of crisis in the first place. Then, it was government remedies, rules, and regulations (like mark-to-market accounting[4]—enacted just weeks before the crisis became a crisis) that turned a run-of-the-mill problem into a catastrophe. Problems spread, and as the saying goes, "When the tide goes out, you can tell who is swimming naked."

Not only did many financial firms fail, which is understandable, but car companies and newspapers that were already on the cusp of serious financial difficultly were pushed into bankruptcy. There was a combination of a lame-duck Bush administration that believed in government spending and a newly elected populist Obama administration that started throwing around trillions of dollars to "save" the financial system. They forced companies to take government money and demonized the capitalist system. As a result, the government became more entangled in the economy than at any time in American history.

In an ironic twist, some pundits measure the depth and breadth of our economic problems by how much the government spent trying to solve it. Federal Judge and University of Chicago Law Professor Richard Posner put it this way:

> [The recession's] gravity is measured not by the unemployment rate but by the dizzying array of programs that the government is deploying and the staggering amounts of money that it is spending or pledging—almost $13 trillion in loans, other investments and guarantees—in an effort to avoid a repetition of the 1930s.[5]

No matter how smart Richard Posner may be, this argument reflects very poor logic. It is the false logic of *post hoc, ergo propter hoc*—after this, then because of this. If the fire department comes to your house and starts chopping holes in your roof, breaking windows, and pumping water everywhere, then your house is supposed to be on fire. But, in reality, it might not be. Fire department activity alone does not prove anything.

The good news is that the fire department doesn't do this. The fire department has nothing to gain by fighting fires that don't exist. However, the government does have something to gain from creating crisis when there is none. This is not some nefarious, black helicopter thought. It is a simple and straightforward thought based on human nature. Groucho Marx once said, "Politics is the art of looking for trouble, finding it, misdiagnosing it, and then misapplying the wrong remedies."

Politicians want to be seen as savior because it wins votes from those who think the government saved them from some terrible fate, whether the threat was real or not. The government also is very fearful that if it doesn't do something to thwart a perceived problem, it will be blamed if things go wrong. As a result, politicians typically overreact. This is what government does; it grows and acts. Sometimes this is just natural instinct, but sometimes it's the desire of those in control.

Rahm Emmanuel, now President Obama's chief of staff, said last November in the early days of transition between President Bush and President Obama that "You never want to let a serious crisis go to waste. And by that I mean to do things you think you could not do before."[6]

But when the government does this—when it grows and acts—it often makes problems worse, not better. The Great Depression is an example of a problem that was made worse by government action—economic growth was decimated because the government interfered in the market process and acted too radically.

Lately, big-government supporters have been arguing that Herbert Hoover and Franklin Roosevelt didn't spend enough in the Great Depression to lift the economy from its crisis. But Hoover lifted federal outlays from 3.4 percent of gross domestic product (GDP) in 1930 to 6.9 percent in 1932. Roosevelt lifted outlays to 8 percent of GDP in 1933, and an average 10.1 percent of GDP between 1934 and 1936.

But spending is only one measure of government activity. As detailed in *The Forgotten Man* by Amity Shlaes, government meddled in just about every arena of economic activity and became extremely aggressive about attacking and regulating businesses:

> Government management of the late 1920s and 1930s hurt the economy. Both Hoover and Roosevelt misstepped in a number of ways. Hoover ordered wages up when they wanted to go

> down. He allowed a disastrous tariff, Smoot-Hawley, to become law when he should have had the sense to block it. He raised taxes when neither citizens individually nor the economy as a whole could afford the change.
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> Roosevelt's errors had a different quality but were equally devastating. He created regulatory, aid, and relief agencies based on the premise that recovery could be achieved only through a large military style effort.
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> Other new institutions, such as the National Recovery Administration, did damage . . . NRA rules were so stringent they perversely hurt businesses. They frightened away capital, and they discouraged employers from hiring workers . . . The resulting hesitation in itself arrested growth.[7]

The good news is that government has shown that it can do the right thing. Contrary to Krugman's point of view, the government behaved in a much better manner during the banking and S&L crisis of the 1980s and 1990s. Between 1980 and 1995, the United States experienced a true financial crisis, with nearly 2,800 banks and S&Ls failing or needing assistance. Despite this, and once the Volcker recessions of the early 1980s were over, the economy prospered, with unemployment falling from 11 percent to 5 percent, while the S&P 500 rose from 102 in 1980 to 616 by the end of 1995—a 500 percent increase.

In that time period, the government did not try to save the day by spending money, cutting interest rates, and taking over financial institutions; it marched to a different drummer. Nondefense government spending (after surging in the recession) was allowed to fall as a share of GDP after 1983. Income tax rates were cut, not hiked. And Paul Volcker at the Federal Reserve held real (or inflation-adjusted) interest rates high to keep inflation low and the dollar strong.

Apparently, government learned nothing from that episode. In the past few years, government spending has exploded, rising from 20 percent to 26 percent of GDP, while the Fed has cut interest rates to near zero. There has been a bipartisan battle cry for government intervention, and it started immediately in August 2007 when financial market problems first appeared. Since then, both Republicans and Democrats, conservatives and liberals, have pushed for more government spending, bailouts, and Fed ease. All of these supporters of government argue that there was no choice, even though it is clear from history there was a choice.

Unfortunately, the alternative choice—to follow free-market, pro-growth, and stable dollar policies like it did in the 1980s—would not grow the government. In other words, this time (as compared to 25 years ago) the government did what it often does and involved itself in a way that made things worse.

All this does not mean that the government has truly killed the goose that lays the golden eggs. Not yet, at least. There is still a vast reservoir of support for free-market capitalism in America. As a sign of this, the May 2009 vote on six ballot measures in California, in the midst of its worst budget crisis in history, showed wide and deep support for lower taxes and less spending. In the end, California's deficit-closing budget, which was finally passed in July 2009, included a heavy emphasis on spending cuts, not tax hikes.

In Illinois, Governor Quinn's 2009 proposal to lift state income tax rates by 50 percent failed miserably in the state legislature. Democratic legislators were scared to vote on a tax hike before the next election. At the same time, the Obama administration found it impossible to break through the bureaucratic logjam and pass cap-and-trade legislation. Health care reform—President Obama's dream to create universal health care in the United States—hit a major roadblock in Congress during the summer of 2009.

And in the midst of all this government activity to "save the world," the economy proved its resilience. In January 2009, while economists were adjusting their forecasts lower to account for what appeared to be a true collapse in global economic activity, U.S. consumers shocked the world and lifted their retail spending by 1.7 percent in one month. Looking back, the economy was already showing signs of a V-shaped recovery when many economists were downgrading their forecasts. The U.S. economy has done this often in the past two centuries.

With the Fed pumping massive amounts of new money into the system and panic subsiding, the economy is set for a surge in growth that will last for the next 12 to 18 months at least. Yes, the path of government policy is problematic for the out years, but for right now things are much brighter than most investors seem willing to contemplate.

History versus Emotion

I know it's hard to believe, in the midst of all of this mayhem, that some good things might actually happen. In fact, there are many who think that acting positive these days is the equivalent of blasphemy.

One of the key ingredients to an optimistic outlook is an ability to think in time, to have a historical perspective. Unfortunately, this is difficult for a great many people. I may sound like an old fogey when I say this, but history has become a boring and meaningless subject to many people. Instead, feelings and emotions seem to have been elevated to the level of truth.

Rightly or wrongly, much of this can be blamed on the ubiquitous nature of the press. This is not the fault of journalists themselves. They are smart people who, if given a chance, could report on history. But they don't have time because they are kept busy responding to the demands of today's audience that we talk about everything that happens as it is happening. This has hurt our willingness, or maybe our ability, to think clearly in the context of history.

Business news is about getting and holding eyeballs, so it tells a story that is easy to follow and very compelling. It often pits the little guy against the corrupt and powerful institutions or people. The most compelling story is the exciting one, with evil businessmen perpetrating some terrible fraud on some unwitting, naïve people.

Think about what makes the regular evening news most nights—murder, crime, flu pandemics, and nasty weather—and how it defines us as helpless victims. Or cable news—which is filled with the drug-induced shenanigans of celebrities or nasty, drawn-out court cases—where human suffering becomes entertainment. While it's not quite as obvious, these are the same audience desires that business news wants to connect with.

This is why business writers and their editors have a deep need to explain every move of every market, every day. As long as the headline says "the market did this *because of that*," then the story is complete. Never mind that one headline about the bond market uses an interpretation of the data that is exactly the opposite interpretation used in a story about the stock market. As long as there is a reason, and preferably one that fits in a headline or screen scroll, then everyone seems happy.

This leads to confusion. Often, there is no real explanation for market movements, or at least one that is obvious. So if we need to say that the market just did what it did because it's the market, then that's okay. It may not sell many newspapers or gather a big audience, but it's better than making up something and confusing people.

What does sell newspapers is reporting on the outliers. Stories about a wreck on the highway or a house that burns down are very sad stories. But they are outliers. A vast majority (99.9 percent) of car trips are safe and successful. And most houses don't burn down. Imagine the news reporting every morning all the names of people who made it to work on time and safely or all the houses that didn't burn down. Who would watch that?

As it is with almost all news reporting, crime gets reported, while "no crime" is taken for granted; successful international treaties negotiated barely make the news at all, but a breakdown in international affairs gets front page headlines. The news is about reporting what goes wrong, not what is normal or what goes smoothly or what is good. The same is true of economic news. It's not for nothing that the vast majority of business news reporting has been about the excitement of bankruptcy, foreclosure, unemployment, or crime. That's what is exciting.

But the true story of business and economics has been one of consistent, but very slow, progress. Living standards have risen, on average, about 2 percent per year for the past 100 years. The day-to-day story of this progress is about as boring as watching paint dry.

Imagine turning on the business news and seeing a story about how UPS uses mathematical algorithms to determine the most time- and fuel-efficient routes for its delivery trucks. Or that General Electric figured out that it could save money by using voice over Internet protocol (VOIP) telephones at its call centers. Or that a small business owner decided to buy a machine and bring a formerly outsourced service in-house to lower costs and cut prices. Or that an entrepreneur had to forget inventing things for a while so that he could teach young employees how to answer the phone and smile at customers.

I'm not saying that any of this news would be popular, even though it is what business and economic progress is all about. In the world of business journalism, it would probably turn up the snooze meter so high that most people would tune out. The end result is that we end up taking the normal progress of the capitalistic system for granted. The everyday activity of the entrepreneur to deliver goods and services at lower cost and higher quality seem to fly under the radar.

With all this reporting of the outliers—the failures—not the progress, investors, consumers, savers, borrowers, retirees, and politicians get a warped sense of perspective. They bounce from one negative issue to another with no way to tie one thing to the next. Everyone becomes an economist, but for only one issue at a time. As a result, there is no comprehensive story about what is happening, what happened, or how we got to where we are.

To make matters worse, the press is typically an ally of government. This happens for two reasons. First, the press is traditionally liberal. While this book is not the place to "prove" this fact, I have spent a great deal of time with the press in my role as a "talking head," and I have experienced this firsthand.

For the most part, coverage of the economy during the election of 2000, which pitted Al Gore (Clinton's vice president) against George Bush, was positive even though there were clear signs of a slowdown and the stock market was falling fast. The press completely missed, or ignored for as long as it could, the recession of 2001. And when the economy was strong in 2004, during the Bush-Kerry contest, the press was still trying to say the economy was weak. The only explanation that makes sense here is that the press was biased.

Second, the press wants (and needs) access to government officials. As a result, the business press will rarely jeopardize that access by writing critical stories. Reporters who write critical stories can be cut off.

This is made even more damaging by the nature of the relationship between the press and the government. When a high government official, like the secretary of the Treasury, travels to a foreign country, some members of the press are asked to travel along on the government plane. This is a privilege, and the invitation can be withdrawn at the whim of the secretary or the press officer.

For a reporter and his or her career, these trips are extremely valuable. Just like war-zone reporting, these trips help journalists "earn their stripes." Reporting on an important economic visit to a foreign government boosts a business reporter's value in the eyes of his peers, the industry, and the world, and most importantly, his boss.

While war-zone reporting and the White House Press Corps are open to just about every accredited media outlet—rarely is anyone excluded—this is less the case with other government agencies. For instance, with the secretary of the Treasury, there is not a large press pool. Only a select few are invited, and if they report in a negative light, they will most likely be left behind the next time. This absolutely must have an impact on the coverage, and it clearly leads to bias.

When Treasury Secretary Timothy Geithner traveled to China last June, he told a group of Chinese students that "Chinese assets [invested in the United States] are very safe." According to a report in the U.K. *Telegraph*, this provoked "loud laughter from the audience of students."[8]

This story was reported by foreign reporters (including the BBC), but apparently was ignored by the press pool traveling with the secretary. The next day, in Beijing, Timothy Geithner sat down with CNBC reporter and press pool member Steve Liesman for a one-on-one interview. He told Steve that the Chinese were confident about U.S. policies and investments. This seems to be a contradiction, or at least one that ignores the students, but one would have to search the Internet to find that out.

Investors who watch the news uncritically, without running it through a filter to adjust for the biases listed above, make decisions based on a questionable and carefully selected set of facts. So today, for example, the conventional wisdom argues that we have experienced a failure of finance or capitalism. At the same time, many journalists suggest that government intervention has been successful, or at least they do their best to ignore any signs to the contrary.

Buck Up and Remember History

There is no doubt that all of this has had a major impact on the psyche of the average investor. In my travels, which take me all over the world talking with market participants, what I sense is a loss of faith in the future. Many have begun to seriously question whether we can return to "normal." For the first time in nearly 30 years, I sense that many worry that their children will have lower living standards than they themselves have enjoyed.

They shouldn't. The U.S. economy has faced much worse times in the past century, yet it has still grown in 80 out of the past 100 years and 45 out of the past 50 years. During that time, per-capita real GDP has nearly tripled. This puts things in a different perspective. And when it comes down to it, perspective is the key to successful living and investing. What I hope to prove in the rest of this book is that it is not as bad as many people think. In fact, I think the future is still pretty darn bright.