October 9, 2012

The first presidential debate left one side energized and the other shaken. The left was intense in its disappointment with their candidate's performance, to the point of ridicule, like comedian Bill Maher saying "He must have taken my million dollars and spent it on weed." Obama's poetic, folksy style may inspire thrills when he preaches to a friendly crowd, but it does not work in a debate against a sharp contender like Romney. The American audience for the debate numbered 67 million, about half the size of the total vote in 2008. Biden and Ryan will debate on Thursday, the 11th, affording another contest in intelligence and competence. The differences between the two men should be starkly evident. Gut feel: Three to one odds that Ryan is seen as superior (this is being written two days before the VP debate).

Not since Roosevelt vs. Hoover has an election had as much portent for the future structure of society. Obama has set a leftward course and wants to keep steering that way, while seeking more taxes, expanding welfare, expanding government regulation, establishing control over a growing list of industries, and now reaching for control over the medical sector of the economy, which accounts for nearly a fifth of GDP. A continuation of that progress for four more years would work profound change in the decision making and responsibility holding functions of our society. That much power concentrated in the hands of several people around one man is excessive, even before considering Obama's base motivational attitudes and the personal relationships that shaped him.

As an aside, one wonders whether, between now and the election, Obama would approve a joint Israeli-US attack that disables Iran's nuclear plants. Aside from such potential game changers, the public evaluation of the upcoming election is progressing and the ripening of opinion is tangible. That may help to explain the strength in stock prices at each new evidence of Obama's fading appeal. Our sense is that the market has been "pricing in" the rising probability that the next administration will prevent the bump up of taxes, usher in policies favoring economic fertility, and turn the US Government away from being our moral guide and allocator of our wealth. That's our job.

Another source of stock market buoyancy may be a spillover of the cash being pumped into the financial system by the Federal Reserve as it issues checks in exchange for government bonds and mortgages. It seems probable that recent monetary policy has already enabled a future cheapening of the dollar, a future acceleration of inflation, which probably will emerge the next time monetary velocity, the frequency by which money changes hands, picks up during a time of more robust growth.

So, even assuming that Republican policy will bring a smaller government and a downturn in government debt, the expanded pool of liquidity multiplied by higher velocity will translate to higher prices and cheaper dollars. That assessment is at the core of our investment strategy. If we are wrong in our political analysis and Obama wins, the implied future would require more intense coping with the debasement of the currency, including use of gold, if prices are not prohibitive at that time.

Europe seems destined to give the world a demonstration of what happens when you do what they have done: Overburden a society by promising social programs funded by rising rates of taxation and borrowing. The political strategy of promising future benefits in return for power stops working when the inevitable failure becomes tangible. The elements of financial healing are reduced consumption,

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write-offs of bad debts, recognition of insolvencies, increased savings, and deleveraging. But the length of time required is hard to know. Perhaps the decade long experience of Japan in the 90s provides some guidance.

Stock prices have been climbing a wall of worry. Reports show that money has been moving away from equity mutual funds, of which some has been redeployed by Exchange Traded Funds, but there is a net outflow, nonetheless. The public, on balance, is stressed by the economic outlook as they perceive it. The movement of money has been into bonds and other forms of debt securities. The suppression of interest returns from high grade bonds and bank savings accounts is pushing income seeking investors into low quality, high yield products. A better alternative is to use income oriented stock funds.

Here is what is on our plate: Momentous political contention in the US, a lighted fuse in the Middle East, and extreme societal forces loose in Europe. That’s the near term. Longer term, the two major subjects to focus on are: How is the economy going to be in the future, and how should the US participate in world affairs in an era of change in the dispersal of the world’s economic and military power. Historically, such periods are characterized by policies which seemed more reasonable at the time than they proved to be in retrospect.

So, what is an investor to do under these circumstances? Cope with inflation primarily through domestic stocks, inflation protected bonds, and direct ownership of appropriate real estate. Debt investments should be at a minimum.

Sincerely,

John May