Lemonade

Organized stock trading in the US can be traced back to the 1700s. However, most people agree that meaningful data originates only a little more than 100 years. Also, some may argue that we really cannot truly study the past until we incorporate the existence of the US Central Bank (The Federal Reserve, established in 1913) because its influence permanently changed the investment landscape. Others note that it was not until the Banking Act of 1935 (which among other things created the FDIC) that you really began to build credible data. This is because prior to the FDIC, major disruptions to the markets involved bank runs, which the FDIC was finally able to reduce.

No matter where we choose to start our examination, there is really nothing in the past that can prepare us for what we are about to experience; actions of historic magnitude. In a very condensed period, the three most powerful economic forces in the US will combine with resulting macroeconomic dictates that will have multi-year impacts on the overall economy and on stock pricing.

So, just what are these "economic forces"? Legislation, the Treasury Department and the Federal Reserve.

Legislation – As of this writing the House and Senate each passed versions of the Stimulus Package ("American Recovery and Reinvestment Plan"). Assuming both houses can reach agreement on a bill to send to President Obama, then we are looking at amounts in the neighborhood of $800 Billion. At its core, the goal is additional money supply which in theory can create more goods and services, If this can be achieved via employment, then the threat of future inflation is somewhat reduced.

Treasury Department – Secretary Geithner presents the Treasury's plan for accelerating money flow (translation – additional money supply) into the real economy. The goal here is to bring (finally, we hope) economic stability to the banking system. Some suggest that even if Mr. Geithner is shown to be a dunce, the Treasury plan will be a dramatic improvement over the self-serving mess known as TARP.

Federal Reserve – What more can "the Fed" do? Already the most accommodative in history, the Bernanke-led Fed has slashed interest rates practically to zero while simultaneously adding guarantees and collateralizations. The latter include soon-to-be announced additional purchases of loan pools including, but not limited to mortgage-backed, auto, consumer, student, and Treasury obligations. Whatever type of loan the Fed purchases, it takes the loan and gives the seller cash. Voila! Additional money supply.

Unfortunately, what is absent are concentrated efforts to correct lax regulation (after all, the private sector knows best, right?!) and manipulative practices that are increasingly recognized as core problems. It is these core problems that led to economic disruptions, which in turn created the necessity for stimulus actions. To be fair, Congressional Committees are (again) looking at actions such as "naked short selling" (I'll explain in another article) which artificially disrupts and depresses prices. The Security industry and its regulators may very well be found complicit in their lack of enforcement.

Another significant issue to resolve is the accounting rule (FASB 157) known as "mark-to-market". By having to value "troubled assets" now at unreasonably low (or unknown) values even though the assets will likely rise back to true values, banks and others are caught in a trap. By suspending artificial accounting rules, we can buy the needed time to recover.

What many have forgotten is that President Roosevelt suspended "mark-to market") in 1938. From 1939 until 2007, the US had relatively subdued business cycles with no panics or depressions, even during the 1980s and 1990s when more than 3000 banks and S&Ls failed. With

Sarbanes-Oxley in 2002 and major accounting rules changed in 2007, mark-to-market made a comeback.

Now, we've got troubles. So what do we do when life (or the economy and the markets in this case) gives us lemons? Let's hope the ingredients we now have before us can be mixed together to give us lemonade.

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