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# The Idle Speculator™

A publication of Symmetry Capital Management, LLC

February 24, 2009

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## Now What?!?

Yesterday extended a week long thrashing of equity markets, and put the S&P only 0.18% above its November low. There were plenty of possible factors at work, most of them relating to rising political uncertainty, or perhaps more accurately, increasing political clarity.

### Bank Fears Return

First, there were rumors swirling around Citigroup preparing to receive additional capital infusions from the government. Perceptions of risk around the large money center banks have continued to intensify during this latest stock market rout, and might be the primary factor behind them.

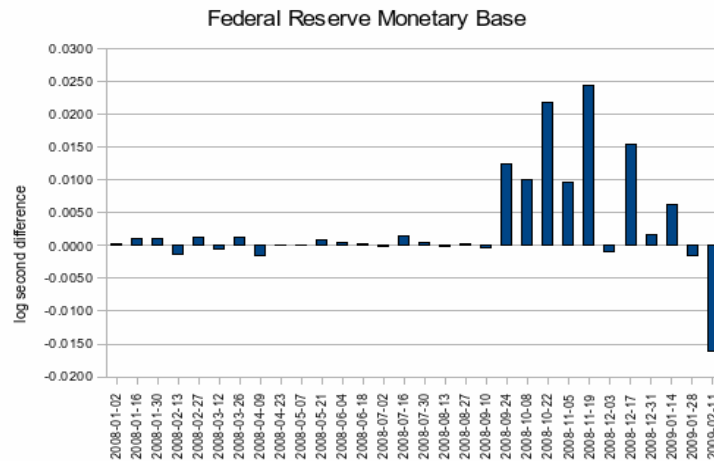
### Budget Fears Rising

Second, markets also had to digest President Obama's convening of a 'fiscal summit' to discuss getting the federal debt under control. This is a *very* high risk tactic. On the one hand, holders of longer term Treasury debt may need to be assuaged, lest interest rates rise significantly. On the other, the last thing an economy in a deep recession needs to learn is that a rising share of shrinking private sector resources are going to be appropriated by the public sector in the years ahead. News of rising taxes on higher incomes is accompanied by ongoing efforts by the Treasury and Congress to crack down on 'tax havens' (normally, when tax loopholes are attacked, tax rates are allowed to fall - not so in the present day, apparently). These kinds of actions raise a remote but serious risk of chasing human capital off shore. Like most forms of capital, the numbers wouldn't need to be large to have significant effects on the U.S. economy. People have clearly been voting "No" with their investment dollars, and might start voting with their feet as well. It's definitely something to watch in the years ahead.

### Quantitative Tightening + Federal Frightening = ?

Finally, the Federal Reserve's balance sheet, the base upon which money and credit depend, has started to contract after a huge run up. We don't know how much this had to do with the equity market decline, but in our view, it - along with the extreme political uncertainty (or increasingly apparent certainty?!?) emanating from Washington - is the most important factor at work right now. Here's why: if the economy is expected to grow at 2% with no inflation, the Fed's interest rate target should be around 2%; if the economy is expected to contract by 2%, a rate of -2% would be appropriate; since the Fed's

operations run into a "zero bound" (their current rate target is 0.25% and operationally speaking, it isn't permitted to go below zero), it has to undertake 'quantitative easing' to get around that. Our estimate of an equilibrium interest rate at this moment is between -2 and -4%, but the Federal Reserve is now engaged in what we might call "quantitative tightening" as its temporary liquidity infusions begin to expire. This is happening at the same time that the federal government seems to be relishing putting the boot even harder to the neck of the private economy. That latter point may sound harsh, but consider that the stimulus package does more dictating to than stimulating of the private sector, and gives the government even greater control over the allocation of resources. On top of that, the promise to raise taxes in coming years has now been made explicit. The upshot is that if these trends continue - if both the Federal Reserve and the federal government continue tightening the screws on the private sector - then our assertion some months ago that the U.S. economy would not enter a depression will have to come off the table, unfortunately. The only available trade off under prevailing mental models is stagflation, via a much easier Federal Reserve.

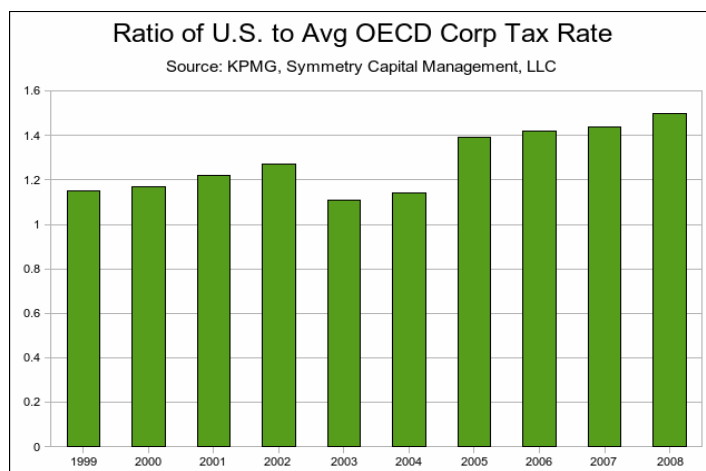


### An Optimal Policy Mix - One More Time!

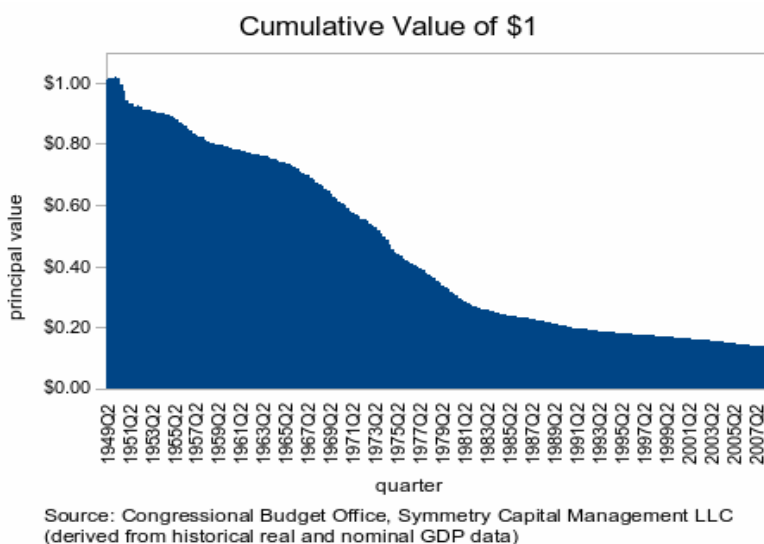
Is there any way out of this mess? There's always time. Time heals all wounds, even those to balance sheets and economies. But how long it takes, and how well things turn out, is uncertain - consider Japan, for example. The safest and surest way out is via an 'optimal policy mix' which we wrote about in September:

[http://www.symmetrycapital.net/idlespeculation/20080925\\_policy\\_mix.pdf](http://www.symmetrycapital.net/idlespeculation/20080925_policy_mix.pdf)

This means serious tax reform - not the nonsense that has been emanating from Congress since 2007, or even the somewhat effective but temporary, piecemeal, and distorting reforms enacted in 2003. It means lasting reforms that make the U.S. private sector more competitive globally, and that reduce or eliminate the many distortions that now affect decisions on saving, working, and investing:



It also means the Federal Reserve providing a more stable dollar, and thus striking a fairer balance between debtors and creditors, or borrowers and savers:



Tall orders to be sure, but ones that we should eventually grope our way towards, just as we did in the early 1960s and late 1970s. The sooner we do so, the better.

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