THE WALL STREET JOURNAL.
WSJ.com

BUSINESS | SEPTEMBER 19, 2009

From Bear to Bull

James Grant argues the latest gloomy forecasts ignore an important lesson of history: The deeper the slump, the zippier the recovery.

By JAMES GRANT

As if they really knew, leading economists predict that recovery from our Great Recession will be plodding, gray and jobless. But they don't know, and can't. The future is unfathomable.

Not famously a glass half-full kind of fellow, I am about to propose that the recovery will be a bit of a barn burner. Not that I can really know, either, the future being what it is. However, though I can't predict, I can guess. No, not "guess." Let us say infer.

The very best investors don't even try to forecast the future. Rather, they seize such opportunities as the present affords them. Henry Singleton, chief executive officer of Teledyne Inc. from the 1960s through the 1980s, was one of these enlightened opportunists. The best plan, he believed, was no plan. Better to approach an uncertain world with an open mind. "I know a lot of people have very strong and definite plans that they've worked out on all kinds of things," Singleton once remarked at a Teledyne annual meeting, "but we're subject to a tremendous number of outside influences and the vast majority of them cannot be predicted. So my idea is to stay flexible." Then how many influences, outside and inside, must bear on the U.S. economy?

Though we can't see into the future, we can observe how people are preparing to meet it. Depleted inventories, bloated jobless rolls and rock-bottom interest rates suggest that people are preparing for to meet it from the inside of a bomb shelter.

The Great Recession destroyed confidence as much as it did jobs and wealth. Here was a slump out of central casting. From the peak, inflation-adjusted gross domestic product has fallen by 3.9%. The meek and mild downturns of 1990-91 and 2001 (each, coincidentally, just eight months long, hardly worth the bother), brought losses to the real GDP of just 1.4% and 0.3%, respectively. The recession that sunk its hooks into the U.S. economy in the fourth quarter of 2007 has set unwanted records in such vital statistical categories as manufacturing and trade inventories (the steepest decline since 1949), capacity utilization (lowest since at least 1967) and industrial production (sharpest fall since 1946).

It isn't just every postwar disturbance that sends Citigroup Inc. (founded in 1812) into the arms of the state or has General Electric Co. (triple-A rated from 1956 to just this past March) borrowing under the wing of the Federal Deposit Insurance Corp. Neither does every recession feature zero percent Treasury bill yields, a coast-to-coast bear market in residential real estate or a Federal Reserve balance sheet beginning to resemble that of the Reserve Bank of Zimbabwe. Yet these things have come to pass.

Americans are blessedly out of practice at bearing up under economic adversity. Individuals take their knocks, always, as do companies and communities. But it has been a generation since a business cycle downturn exacted the collective pain that this one has done. Knocked for a loop, we forget a truism. With regard to the recession that precedes the forecasting consensus, Michael T. Darda, chief economist of MKM Partners, Greenwich, Conn.: "[T]he most important determinant of the strength of an economy recovery is the depth of the downturn that preceded it. There are no exceptions to this rule, including the 1929-1939 period."

Growth snapped back following the depressions of 1893-94, 1907-08, 1920-21 and 1929-33. If ugly downturns made for torpid recoveries, as today's economists suggest, the economic history of this country would have to be rewritten. Amity Shlaes, in her "The Forgotten Man," a history of the Depression, shows what the New Deal failed to achieve in the way of long-term economic stimulus. However, in the first full year of the administration of Franklin D. Roosevelt (and the first full year of recovery from the Great Depression), inflation-adjusted gross national product spurted by 17.3%. Many were caught short. Among his first acts in office, Roosevelt had closed the banks. He had excoriated the bankers, devalued the dollar, called in the people's gold and instituted, through the National Industrial Recovery Act, a program of coerced reflation.

"At the business trough in 1933," Mr. Darda points out, "the unemployment rate stood at 25% (if there had been a 'U6' version of labor underutilization then, it likely would have been about 44% vs. 16.8% today. . .). At the same time, the consumption share of GDP was above 80% in 1933 and the household savings rate was negative. Yet, in the four years that followed, the economy expanded at a 9.5% annual average rate while the unemployment rate dropped 10.6 percentage points." Not even this mighty leap restored the 27% of 1929 GNP that the Depression had devoured. But the economy's lurch to the upside in the politically inhospitable mid-1930s should serve to blunt the force of the line of argument that the 2009-10 recovery is doomed because private enterprise is no longer practiced in the 50 states.

To the English economist Arthur C. Pigou is credited a bon mot that exactly frames the issue. "The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant." So it is today. Paul A. Volcker, Warren Buffett, Ben S. Bernanke and economists too numerous to mention are on record talking down the recovery before it fairly gets started. They collectively paint the picture of an economy that got drunk, fell down a flight of stairs, broke a leg and deserves to be lying flat on its back in the hospital contemplating the wages of sin. Among economists polled by Bloomberg News, the median 2010 GDP forecast is for 2.4% growth. It would be a unusually flat rebound from a full-bodied downturn.

Our recession, though a mere inconvenience compared to some of the cyclical snows of yesteryear, does bear comparison with the slump of 1981-82. In the worst quarter of that contraction, the first three months of 1982, real GDP shrank at an annual rate of 6.4%, matching the steepest drop of the current recession, which was registered in the first quarter of 2009. Yet the Reagan recovery, starting in the first quarter of 1983, rushed along at quarterly growth rates (expressed as annual rates of change) over the next six quarters of 5.1%, 9.3%, 8.1%, 8.5%, 8.0% and 7.1%. Not until the third quarter of 1984 did real quarterly GDP growth drop below 5%.

One may observe that Ronald Reagan stood for enterprise, free trade and low taxes, whereas Barack Obama stands for other things. Yet President Obama's economic policies seem almost as far removed from Roosevelt's as they are from Reagan's. (Not for Obama, at least not yet, is a new National Recovery Administration). Certainly, Roosevelt never attempted anything like the fiscal and monetary resuscitation organized over the past 12 months. In the post World War II era, the government has attacked recessions with an average fiscal stimulus of 2.6% of GDP and an average monetary stimulus of 0.3% of GDP, for a combined countercyclical lift of 2.9%. (Fiscal stimulus I define as the cumulative change in the federal budget, monetary stimulus as the cumulative change in the Fed's balance sheet, both measured from the peak of the boom to the trough of the bust.) This time out, the fiscal stimulus is likely to measure 10% of GDP, monetary stimulus 9.5% of GDP, for a combined pick-me-up equivalent to 19.5% of GDP. Our Great Recession would be marked for greatness if for no other reason than by the outpouring of federal dollars to repress it.

What did we do before Timothy Geithner and Ben Bernanke? In the day, it was the self-regenerative power of markets that lifted us off the rocks. The brutality of the depression of the early 1920s could not have been far from the mind of President Harry S. Truman as he signed into law the 1946 act to make it the government's business to maintain the economy at full employment. That 1920-21 crackup featured a deflationary collapse—wholesale prices plunged by 37%—and, by 21st century lights, a highly unconventional set of government measures to set things right. To meet the downturn, the Fed raised, not lowered, interest rates and Congress balanced the budget—indeed, ran a surplus. Yet the depression ended. How, exactly, did it end? Falling prices opened wallets, the monetary historian Allan H. Meltzer explains. Finding bargains, consumers and investors snapped them up. "The fall in market prices raised the public's stock of real [money] balances above the desired amount, just as if the Federal Reserve had increased base money at a constant price level," Mr. Meltzer relates in his "A History of the Federal Reserve." After falling by 4.4% in 1920 and by 8.7% in 1921, inflation-adjusted GNP shot up by 15.8% in 1922 and by 12.1% in 1923.

Bargain-hunting is the balm of recovery even today, dead set against low prices the Federal Reserve might be. Detroit is a living laboratory in many things, including the so-called real balance effect. As Marshall Mandall, a RE/MAX agent in that city, tells the story, house prices are still falling at the high end of the market, though they have stabilized at the low end. Transaction volumes are rising. Speculators are on the prowl, but so, too, are ordinary home buyers. It seems—who'd have guessed it?—that value sells. "They can buy something for half of what they could three years ago," Mr. Mandall says. "Everybody perceives bargains in their house-hunting." At the end of the second quarter, according to the Detroit Free Press, the supply of unsold houses was equivalent to 8.5 months' sales, down 39% from the year before.

Through the first six months of 2009, the Case-Shiller 10-City Composite index of house prices fell by 5.5% compared to year-end 2008. However, the rate of decline has been slowing and, indeed, the index recorded month-to-month appreciation in May and June. It may just be that the Fed's assumption of a 14% decline in prices this year (built into the base case of its bank stress test) is unrealistically bearish.

The Fed's voice is among the saddest in the lugubrious choir of bearish forecasters, and for good reason. By instigating a debt boom, the Bank of Bernanke (and of his predecessor, Alan Greenspan) was instrumental in causing our troubles. You might have thought that it would therefore see them coming. Not at all. Belatedly grasping how bad was bad, it has thrown the kitchen sink at them. And it maintains this stance of radical ease lest it get the blame for a relapse. However, by driving money market interest rates to zero and by setting all-time American records in money-printing ($1.2 trillion conjured in the past 12 months), the Fed is putting the value of the dollar at risk. Its wide-open policy all but begs our foreign creditors to ask the fatal question, What is the dollar, anyway? Why, the dollar is a scrap of paper, or an electronic impulse, the value of which is anchored by the analytical acuity of the monetary bureaucracy that failed to predict the greatest financial crackup since the 1930s.

The Fed may be worried about something else. By sitting on interest rates, it is distorting every business and investment decision. If mispriced debt was the root cause of the narrowly-averted destruction of global finance, the Fed is well on its way to setting the stage for some distant (let us hope) Act II. In the meantime, ultra-low interest rates have lit a fire under the stock and debt markets.

By rallying, equities and corporate bonds not only anticipate recovery, but they also help to bring it to fruition. By opening their arms wide to such previously unfinanceable businesses as AMR Corp., parent of American Airlines, and Delta Air Lines Inc., the newly confident credit markets are implementing their own stimulus program. "Reflexivity" is the three-dollar word coined by the speculator George Soros to describe the dual effect of market oscillations. Not only does the rise and fall of the averages reflect economic reality, but it also changes it. One year ago, the Wall Street liquidation stopped world commerce in its tracks. Today's bull markets are helping to revive it.

I promised to be bullish , and I am (for once)—bullish on the prospects for unscripted strength in business activity. So, too, is the Economic Cycle Research Institute, New York, which was founded by the late Geoffrey Moore and can trace its intellectual heritage back to the great business-cycle theorist Wesley C. Mitchell. The institute's long leading index of the U.S. economy, along with supporting sub-indices, are making 26-year highs and point to the strongest bounce-back since 1983. A second nonconformist, the previously cited Mr. Darda, notes that the last time a recession ravaged the labor market as badly as this one has, the years were 1957-58 —after which, payrolls climbed by a hefty 4.5% in the first year of an ensuing 24-month expansion. Which is not to say, he cautions, that growth this time will match that pace, only that growth is likely to surprise by its strength, not weakness.

And that is my case, too. The world is positioned for disappointment. But, in economic and financial matters, the world rarely gets what it expects. Pigou had humanity's number. The "error of pessimism" is born the size of a full-grown man—the size of the average adult economist, for example.

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