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INVESTOR ALERT

TOP-DOWN INSIGHTS...BOTTOM-LINE RESULTS

Those Alleged "Stimulus" Measures

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U.S. stock prices have recovered a bit in recent days. Economists and analysts are attributing the revival to the so-called "stimulus" measures being discussed and approved in Washington. Don't believe it. Remember, at the same time, political commentators since September 11th have been predicting (quite rightly) that in the aftermath of the terrorist attacks – and the U.S. military response, if any – we'll be seeing an even bigger and more intrusive government.[1] History shows unequivocally that a bigger and more interventionist state (a.k.a., socialism) is certainly no "stimulus" to money-making or markets.

"Stimulus" measures – or new government burdens on the economy? Which shall predominate?

President Bush reflects the contradictions embedded in recent "stimulus" plans. He told advisors recently that "we are both supply-siders and Keynesians."[2] Mr. Bush seems unaware that these are *opposite* schools of economic thought, offering wildly opposite policy proposals. Apparently he sees them as *complementary*. Of course, the President's misguided interpretation isn't at all unique; in fact it's quite typical of the eclectic (*i.e.*, confused) state of modern economics (and of his economic advisors).

Supply-side economics focuses on the incentives faced by producers, savers and investors and counsels a policy mix that entails sound money, low interest rates, low tax rates, deregulation and free trade. In contrast, *demand-side* economics[3] focuses on consumer spending[4] and advises an interventionist-socialist policy mix of inflationism ("more liquidity"), higher interest rates (to "fight inflation"), high and graduated tax rates, government spending schemes, regulation and protectionism. Supply-side policies foster a vibrant, prosperous economy; demand-side policies deliver a stagnant, declining economy. A mongrel mix of the two merely creates an economy that goes through successive cycles of prosperity and stagnation.

The Bush approach ("we are both supply-siders and Keynesians") makes for schizophrenic economic policy and its result: both rising and falling markets. In effect, he has said: "We favor policies that create wealth as well as policies that destroy it." Depending on the mix, the net effect isn't necessarily "stimulative."

We don't deny that some of the "stimulus" measures currently being discussed might deliver their intended effect – especially if the measures were to involve *tax cuts*, and especially tax cuts *for the highest-*

[1] See "Re-regulation: Terror Attack Reverses a Two-Decade Drive to Shrink Government," *The Wall Street Journal*, September 26, 2001, p. A1.
[2] Cited in "Re-regulation: Terror Attack Reverses a Two-Decade Drive to Shrink Government," *The Wall Street Journal*, September 26, 2001, p. A1.
[3] Demand-side economics comes in two varieties: Keynesian and Monetarist. The first seeks to boost demand (consumption) through fiscal policy, especially government deficit spending; the second seeks to boost it by printing money.
[4] It focuses especially on *government* spending – since government is the single biggest *consumer of resources* in the U.S. economy. As such, it's also the economy's biggest destroyer of wealth. The destruction caused by other means, such as domestic crime or by foreign invasion has, (so far) paled in comparison to the wealth destroyed by duly elected officials.

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earning producers and investors, and especially *large* tax cuts – and especially those which take effect *quickly*. But so far, most of the measures that have been implemented and many of those being seriously proposed are nothing more than net wealth destroyers. The main offset to these measures is the Fed's rate cutting which, after a lag, is bullish.

Since September 11th we can count as much as $100 billion in additional federal spending measures, most of which have been labeled (falsely) as "stimulative:" 1) $20 billion to repair and rebuild New York City, 2) $20 billion for victims of the terrorist attacks, 3) $25 billion for airlines, 4) $17 billion more for the Pentagon, and 5) $5 billion to extend unemployment benefits. There are also proposals for tax cuts in which the revenue loss hasn't yet been fully assessed. But there is abundant opposition to such cuts, as the politicians bow to the Holy Grail of a balanced budget (and steadfastly refuse to cut spending elsewhere).

Below we analyze these measures, with the aim of discerning whether they'd create or destroy wealth. Keep in mind that *no* government spending measure can be said to involve the creation of wealth – and thus can't be "stimulative." Government spends no money that it doesn't first 1) *take* from producers (in taxes) or 2) *borrow* from markets, thereby competing unfairly[5] with producers who wish to borrow, or 3) *print* (which represents a dilution of the purchasing power of every producer in the economy). The only true "stimulus package" involves *tax cuts* and *appreciating money* (which also entails lower interest rates).

Rebuilding in New York City. The acts of September 11th represented a vast destruction of wealth, not only of physical but of human capital (some of the brightest minds on Wall Street). The initial destruction will have reverberating, negative effects in the region because of its disruptive effect on business and business confidence. There can be nothing "stimulative," per se about rebuilding what was lost.[6]

Demolition crews, construction crews and materials deployed at the World Trade Center site cannot be deployed elsewhere, as they once were. Economic activity necessarily declines elsewhere. Resources are merely shifted, but certainly not increased on a net basis nationwide. Any attempt to rebuild will only mean a return, in some degree, to the original position. And it isn't even clear, as yet, that towers of equal magnitude will be built in place of the World Trade Center. Some officials want to turn the sight into a park or mausoleum, as was done in Oklahoma City. If the towers are not rebuilt, in some form at least, then to that extent less wealth will be produced in New York. That certainly is not a "stimulative" act.

Even if re-building does take place in New York City, funded to the tune of $20 billion by the federal government (as proposed), it would not represent a net "stimulative" act for the U.S. economy as a whole. It would stimulate development locally, but at the expense of development elsewhere, since the $20 billion must come from government taxing others, or by borrowing or by printing it. And worse, by the nature of government funding, it would be an inefficient re-building, laced with graft and waste.[7] Thus the rebuilding is likely to involve a net destruction of wealth. The only way to avoid piling such a tragedy atop an existing tragedy is to have a fully *private* project; but few officials seem willing to allow that to occur.

Aid to victims. Congress has also allocated $20 billion to the living victims of the September 11th attack – the dependents of those who were murdered and maimed, the surviving businesses that were disrupted, the owners of the buildings that were destroyed, the mortgage holders, possibly even the city tax revenues that were lost. The full details have not been worked out. But it is undeni-

[5] We say "unfairly" because the government, with its power to tax and its unquestioned credit rating, is thereby able to pay a substantially lower interest rate on borrowings than do private borrowers.

[6] For more on this point, what Henry Hazlitt called "the Broken Window Fallacy," see his book, *Economics in One Lesson* (San Francisco: Laissez-Faire Books, 1996), Chapter One.

[7] An example of waste on a vast scale is the "Big Dig" project in downtown Boston (to submerge the central artery), a project which has seen corruption, cost overruns and delays due primarily to the project's extensive government funding.

able that such a package is not a net "stimulant" for the U.S. economy. It helps some – and certainly each victim deserves to be compensated by government for its failure to protect life and property – but the source of the funds necessarily comes from taxing or borrowing or printing money, which can only come from producers.

The airlines. Last week Congress also approved – and the President signed – a $20-25 billion "bailout" package[8] for the airlines, consisting of 1) $5 billion in direct payments (to be allocated proportionately, based on airlines' revenues)[9] through the end of this year, to compensate for losses due to the terrorist assaults and the government's 3-day shutdown of the nation's air space and 2) $10 billion in loan guarantees to prevent airline defaults. There is also discussion of a plan to put federal sky marshals on planes and to have the federal government take over airport security and screening. Currently the airlines pay $1 billion to subcontractors and security firms. That would represent a saving for the airlines but no net benefit for the economy since government must tax or borrow to pay for the security and the marshals. Based on normal flight volumes, it's estimated that 14,000 marshals might be needed, costing at least $1 billion.

The package also establishes 3) an *open-ended* government compensation fund, which could easily reach $2 billion, to compensate victims and their families for damages (other than punitive damages), in lieu of going to court, 4) reimbursement for likely increases in the insurance premiums carriers would otherwise have to pay and 5) government payments for certain terrorism-related losses over $100 million that might occur over the next half-year. This latter measure could cost as much as $1 billion. The cost of the fourth item is virtually unknown, since it depends on how well the U.S. defends against further terrorist attacks.

This package also involves no stimulus for the nation's economy, overall. There are no discussions of tax breaks for airlines, because they were losing money even before the attack. Government spending helps the industry directly but indirectly hurts everyone else who must pay the taxes to support the plan, or who must forego borrowing (or pay higher borrowing costs) because of government borrowing to fund the plan, or those who will be subjected to the theft of inflation should government choose to print the money. The costs could be any – or all – of these. And in total they are likely to exceed the concentrated benefits that some airlines will see.

But the airlines will also be burdened by stringent new security measures, by the extra costs associated with them and by the lower travel volumes that such measures will cause.[10] The airlines may also face higher landing fees and gate fees – or at least no lower ones, which would otherwise be warranted in the new, low-volume setting – as quasi-public airport authorities try to preserve their own revenue streams.

There is no doubt that airlines in the U.S. have to recover financially if U.S. business is to fully revive. We're not against some measures to assist them. But they could rely more on tax reductions and deregulation than they do now. Again, the airlines are victims of an atrocious and irresponsible national defense effort. This is no "bailout" of an irresponsible industry that failed on its own. Calling it that only adds insult to injury. It's the government's fault and government should rectify it by making the airlines whole. It could accomplish this quite easily by funding the plan through *cutbacks in government spending elsewhere*. But Congress has made no such attempt. They have more than enough economists and policymakers telling them exactly what they want to hear: keep spending, and ever more quickly, to "stimulate" the economy.

Making someone whole does not put them ahead

[8] See "U.S. Bailout Will Keep Airlines Flying Amid Downturn," *The Wall Street Journal*, September 24, 2001, p. A3.
[9] Passenger carriers will receive $4.5 billion; freight carriers will receive the balance ($500 million). American Airlines represents about 20% of all revenues in the passenger business, so it'll receive about $900 million.
[10] There will be additional costs imposed on the economy, though not on the airlines directly, associated with the time and money wasted by millions of business travelers who will wait in still longer lines, misallocating still more of their valuable time (than they already did before September 11th) to airport visits.

of the game, which is what a stimulus package is supposed to entail. It merely puts them back where they were – and at the cost of setting back other taxpayers, borrowers or money-holders. This is not a plan that is "stimulative" for the U.S. economy as a whole. But neither does it seem particularly destructive of wealth, given the problems that would ensue if the airlines went bankrupt (as they well might, otherwise) and if the government then nationalized them and ran them as efficiently (and safely) as it's run Amtrak (a.k.a., "Slamtrak") over the last three decades.[11]

More Pentagon spending. Congress is also likely to allocate an additional $17 billion to the Pentagon, in part to repair its headquarters and in part to fund a war effort. In the first place, we think it's doubtful that there will actually *be* a full-scale "war effort." There *should* be – and that *would* be "stimulative" for the economy, not because of the extra spending but because a major threat would be removed (permitting less military spending in the future, as occurred after the Soviet Union dissolved) and because business confidence would be restored. But we doubt that the U.S. response will involve much beyond a few commando raids and the lobbing of missiles into generally innocuous areas. No terrorist nations are likely to be taken out.

At any rate, it's important for investors to realize that military spending per se is not "stimulative" – even though that's been the prevailing view of Keynesian professors who've taught (falsely) that what finally retrieved the U.S. from the depression in the 1930s was spending for World War II.[12] Not so. War is, ultimately, a destructive act, even if it has its positive and bullish good side, which is the destruction of the destroyers.

It's not new spending at the Pentagon that could prove "stimulative" to the U.S. economy but instead a swift, forceful and comprehensive deployment of the skills, personnel and armaments – which the Pentagon has *already* accumulated over the years – to vanquish the world's terrorist nations. But again, we doubt, based on the history of U.S. appeasement of terrorism[13] and the administration's statements and actions since September 11th,[14] that the Pentagon will actually execute such a just and bullish mission.

Paying people not to produce. Today President Bush asked Congress to pay for *thirteen extra weeks* of benefits for the unemployed.[15] Normally unemployment compensation is the purview of states. Bush recommends that Congress give the states $3 billion to handle jobless new claims. He also wants Congress to add further to state-level spending, to pay for the 50% extension of the eligibility period.

This is a wealth-destroying policy, since it takes money from people who work (produce) and subsidizes people who don't. All else equal, this policy will raise the unemployment rate (currently 4.9%) over the coming year, to a level higher than it might otherwise have reached. And all else equal that will also depress the rate of economic growth.

Proposed tax cuts – strictly backseat? Lastly we address the few tax cuts proposals that have been proposed in recent weeks. The most important, for investors and the future direction of the market, is the bill recently introduced and sponsored by Senators Phil Gramm (R-Texas) and Zell Miller (D-Georgia) to cut the capital gains tax rate in half from its current rate of 20%. Next in order of importance and the most bullish in their impact are proposals to 1) permit accelerated depreciation of

[11] Since the U.S. government took over passenger rail service in America the 1970s, Amtrak has never made any money and in fact has lost billions. Its deficits have been funded by taxpayer subsidies and it has had an atrocious safety record. Nevertheless, Congress is now seeking to spend even more on Amtrak. And on September 25th Representative Don Young (R-Alaska) introduced a bill to provide $71 billion in tax-exempt bonds, government loans and government loan guarantees to build a nationwide network of high speed trains.
[12] In this regard recall, as well, the rather misguided views of President Eisenhower, who warned against what he saw as "a military-industrial complex" that allegedly had industrialists craving war so they could build and sell more armaments. If that were so, the U.S. surely wouldn't have so "demilitarized" itself from 1974 to 1981 and again from 1991 to 2001.
[13] See "Terrorism and Its Appeasement," *The Capitalist Advisor*, InterMarket Forecasting, Inc., September 17, 2001.
[14] See "U.S. Officials Fiddle While America Burns," *The Capitalist Advisor*, September 22, 2001.
[15] "Bush Urges Help for Unemployed," MSNBC, October 4, 2001. The article begins with the claim that Bush's request is an attempt "to revive a slumping American economy." Of course, paying people not to work does the precise opposite; but the writer analyzes it from the demand side, impervious to the fact that recipients won't be *producing*. He thinks it's bullish that they'll still be *consuming* the product of others.

investment in business equipment,[16] 2) cut the corporate income tax rate, from its current level of 35%, and 3) accelerate the marginal tax rate cuts on personal income that have began to take effect but which are currently phased in gradually over a six year period. These are the only truly "stimulative" acts that have been proposed.

These tax cuts would surely have some positive effect on the economy and markets if they were to take effect (and quickly). Unfortunately, so far the discussions and proposals regarding tax cuts have been timid and tentative. The magnitude of the cuts being proposed is not substantial and even those that might be implemented might well be delayed.

What's holding things up? The same Congressmen who've yet to formally issue a Declaration of War against terrorist nations have nevertheless continued their Class Warfare tactics against the rich (and any colleagues they can find defending tax cuts for the rich). Others are blocking tax cuts by stressing the primacy of budget balancing. The few Congressmen (and economists) who *do* support tax cuts are stressing only those with a demand-side (consumptionist) element to them – such as "putting more money in the pockets of the poor," those who'll spend most of it.

Here's what we've seen so far see: 1) massive new government spending which is not "stimulative," 2) class warfare in the debate on tax cuts, 3) placing the government's finances (a balanced budget) above those of producers, and 4) a focus on tax breaks for the poor instead of for investors and entrepreneurs.

This is not what revives an economy. For investors wishing to "handicap" the various stimulus packages as they are debated and move their way through Congress, we offer the following tip sheet:

Policies that would foster wealth creation:

- Fed rate cuts – the sooner, the better.
- Cuts in the capital gains tax rate – the sooner, the better.
- Accelerated depreciation for business capital investment – the sooner, the better.
- Lower corporate income tax rates – the sooner, the better.
- Cuts in marginal income tax rates, especially for the *highest* earners – the sooner, the better.

Policies which are neutral toward wealth creation:

- Spending to make the airlines whole
- Tax cuts for low-income earners or the poor

Policies that would destroy wealth:

- Government spending other than that needed to make the airlines whole.
- Fed creation of *excess* "liquidity" – as reflected in a rising gold price.
- Any increases in tax rates or government fees, especially on producers.
- Extended government benefits for the unemployed.
- Subsidies to loss-making modes of transportation (like Amtrak).
- An interminable war in which U.S. wealth is eaten up in wartime destruction.
- A foreign policy that continues to appease terrorism and leave the U.S. exposed to attack.

The "almighty consumer" – destroyer of wealth. Despite the success of supply-side policies in the 1980s and 1990s, demand-side economics hasn't been vanquished. Most economists, policymakers and journalists remain obsessed about the state of the consumer, about "consumer confidence" and the rapidity of "consumer spending." They believe the consumer is a barometer of future economic growth, as if consumption is the cause, not the consequence, of wealth creation.

It's all so pathetically illogical, when it's not outright laughable. For by *definition* "consumption" entails *the using up or destroying of wealth*. An act that *destroys* wealth (especially "confidently") can't also be said to *create* wealth – let alone forecast its rate of

[16] This would lower taxable income and taxes, raise corporate cash flows and permit higher equity prices.

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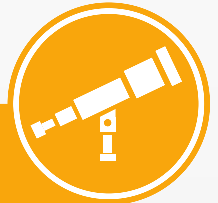

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growth.[17] If economists and policymakers truly care about "boosting the economy," as they claim, they would care primarily about *producer confidence* and *producer spending* (which is *productive* spending, with *profit* as the goal – profit being *net production*). An "economy" is made primarily by the *producers*, not by the consumers; there can be no consuming without first producing.

Greater wealth production doesn't result from some Keynesian "multiplier effect" flowing from deficit-financed government boondoggles – nor does it result from "patriotic purchases" – nor from consumers with a "high marginal propensity to consume" – nor from bureaucrats who are given ever-greater powers to tax and redistribute wealth.

The greater production of wealth results only when *producers* – especially business executives, entrepreneurs and investors – *expect to earn higher rates of profit or capital gains*. Investors should handicap every "stimulus" package they hear about by this gauge: Is the package likely (or not) to foster *higher rates of profit and/or capital gains for producers*? That's it. That's the main yardstick. So-called economic "stimulus" packages that include anything *other* than deep tax cuts for producers, savers and investors – such as spending schemes or tax rebates to boost consumption – tend to exert, if anything, a *deadening* effect.

Upon close examination, there are many more Keynesian, demand-side elements (promoting consumption) in the current "stimulus" packages than there are supply-side elements (promoting production). Markets are likely to respond to this mongrel policy in an understandably mixed fashion.[18] The U.S. equity market will revive precisely to the extent shifts in U.S. economic policy involve *sounder money, less regulation (including less trust-busting)* and *lower tax rates, especially for the country's top producers and investors.* And the more quickly such policies are implemented, the sooner (and more permanently) the market will revive.

What counts. At this stage in the cycle investors can only be thankful that the Fed has cut rates by 4 percentage points, to 2.5%. With a lag, that will be truly "stimulative" – and it will dwarf the alleged "fiscal stimulus" that everyone's now talking about. In the meantime, investors shouldn't presume that anything coming from Congress will, alone, permanently lift the market – or that the market, in lifting off briefly here and there, is responding to any Congressional-based stimulus. If markets do rebound firmly, it will be because top producers are likely to be getting real tax cuts, not because government is likely to be dissipating wealth by engaging in yet another spending boondoggle dressed up as "compassion" and "stimulus."

[17] Here, of course, we refer to consumers *strictly in their capacity as consumers*, while recognizing that most of them, in working, are also *producers*. But consumption, by itself, is *not* production, nor a spur to it; it's the *opposite* of production.

[18] Here we speak only of the effects of the fiscal-regulatory packages now being proposed. Fed policy is another matter entirely and all else equal that policy is bullish. The Fed funds rate is now 4 percentage points lower than it was a year ago – and at a 39-year low of 2.5%. But the full, bullish impact of these rate cuts on output growth and profits won't show up until next year; the more the Fed *promises* future cuts (with its "bias statements") and the longer its takes to enact them, the more their ultimate impact will be postponed. See "The Waiting Game," *Investor Alert*, InterMarket Forecasting, Inc., August 21, 2001 and "Better Policy Deferred is Not What Markets Prefer," *Investor Alert*, InterMarket Forecasting, Inc., March 16, 2001.