Bad Government Policies Do Have Consequences

With apologies to Chuck Berry…

I'm gonna write a little column,
Gonna mail it to the FOMC
It's a rockin' rhythm record
Of what they're doin' to me
Roll over Greenspan, you better read it and see

You know, bond prices are risin'
And the Nasdaq's blowing a fuse
Metals are sinkin'
And funds keep singin' the blues
Roll over Greenspan, and tell Dick Cheney the news

Call in the Pundit Principle: The greater the catastrophe, the denser the analysis. Will there ever again be a home movie more studied than the Zapruder film? More to today's point, will there ever be an economic event more studied than the Great Depression?

Two reasons why a normal inventory correction begun in 1928 and a burst financial bubble in 1929 turned so bad can be traced to:

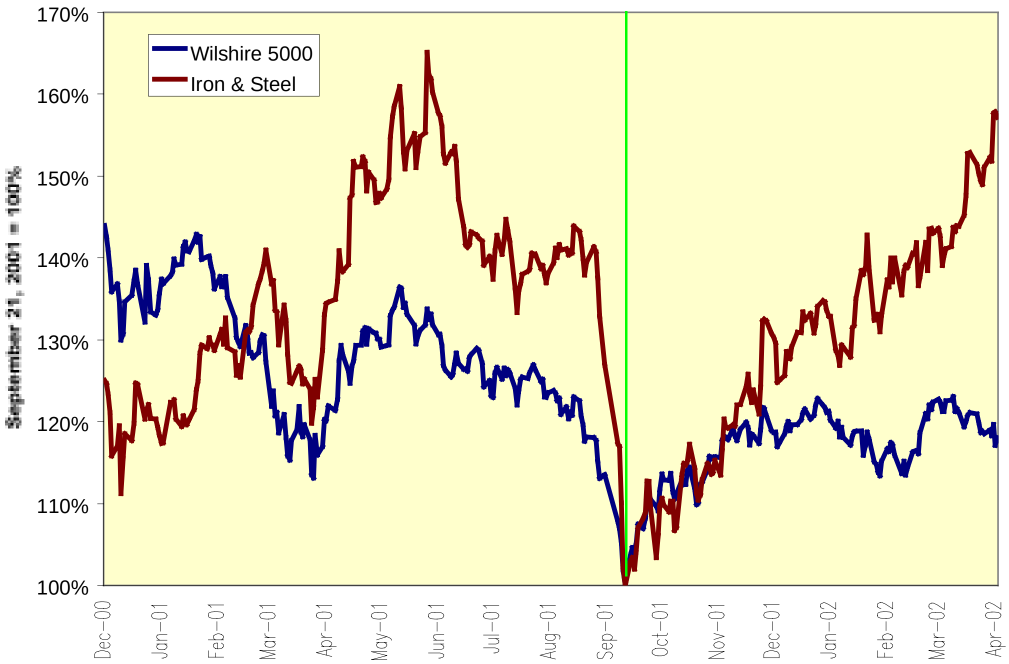
1. A global bout of protectionism highlighted by the U.S. Smoot-Hawley tariff of 1930; and
2. A series of mistakes by the Federal Reserve that allowed for a one-third contraction in the money supply despite a string of rate cuts.

The Less Things Change, The More They Stay The Same
So, what do we have today? Let's call it 1930 Lite, and take a look at the international trade side of the equation first.

The decisions in March to impose tariffs and other trade barriers on steel and Canadian lumber constitute a piecemeal reversion to protectionism. As a de facto tax increase on industries ranging from oil & gas exploration to automobiles to housing, these levies will do much to damage the nascent economic recovery and, if past is prologue, they won't do much to help the industries targeted for the tariff protection. If you want an industry to ossify, put it behind a tariff wall: It becomes insulated from market forces signaling it to reduce costs while its competitors must become more efficient. Steel has been replaced by aluminum and engineered plastics, amongst other materials, since protection began in the Nixon administration. To be fair, steel production is subsidized worldwide, and most nations lack U.S. environmental restrictions and worker health and safety standards. But why should other steel consumers and I be prevented from buying what others are foolish enough to give away to us?

Interestingly enough, the 14-member Bloomberg iron and steel index, which is led by Nucor, Allegheny Technologies, U.S. Steel, Reliance Steel, Steel Dynamics and AK Steel, has outperformed the broad U.S. market ever since it became apparent that George W. Bush would become president in mid-December 2000. But this has not been a uniform outperformance; the steel industry fell sharply in 2001 as the recession took hold. This was to be expected, so from whence did the longer-term outperformance derive?

Steel Wheels



The March 4, 2002 announcement of the steel tariff had a positive, but not gigantic, effect on the relative performance of the domestic steel industry. The key event appears to be the September 21, 2001 market low. The rescue of the airline industry may have sent a signal to all industries looking to Washington that it was now open season for handouts.

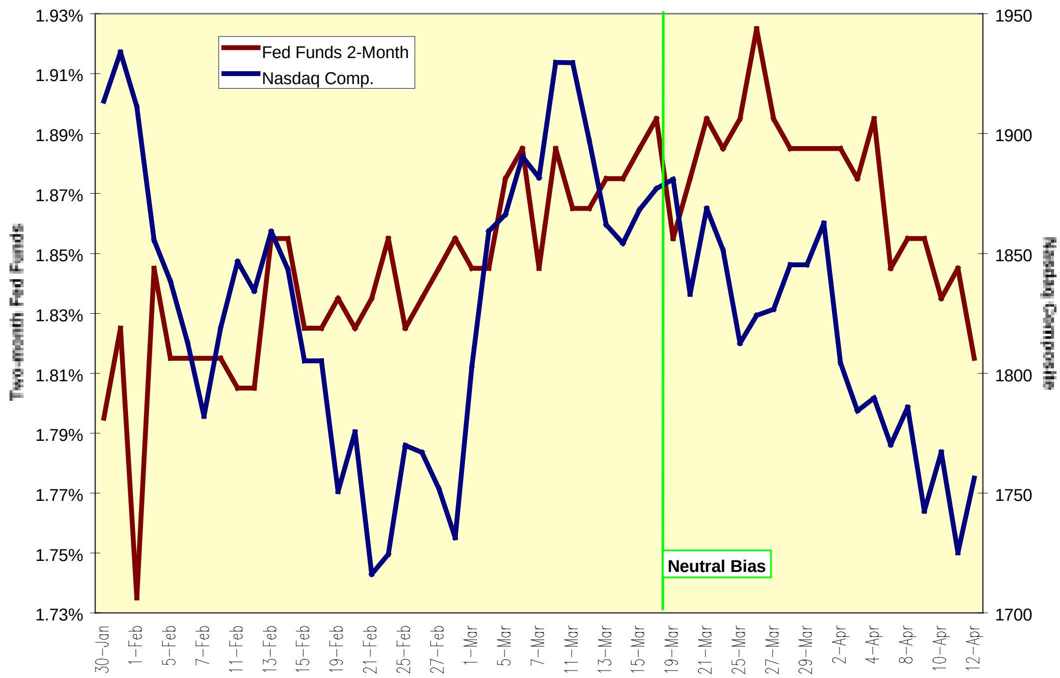
The Monetary Briar Patch

It wasn't too long ago that I was pretty supportive on stocks, especially relative to bonds. The economic news was not as bad as feared, and all sorts of my favorite little indicators, including the Baltic Dry Freight Index and the prices of industrial metals, were flashing green. Heck, it was only three weeks ago that I updated you on the progress of my New Year's predictions, which included a promise to admit immediately when the market proved me wrong.

The fictional Max Bialystok in Mel Brooks' *The Producers* looks heavenward when, you've got to be kidding, the play turns into a success and implores, "Where did I go right?" That's the market's problem right now: Things started to go right. Once this happened, the fear became the Fed starting to raise interest rates and take away the proverbial punch bowl before the party even started.

We know the good news; you can read it here and elsewhere every day. And you know the bad news out of the Middle East regarding energy prices. Let's remove both of these from the equation as best as we can by ignoring the senior commodity indices. A simple look at the two-month Fed Funds rate and the woebegone Nasdaq Composite since the January 30th FOMC meeting, the last one with a proclaimed bias toward neutrality, will suffice.

Rational Acceptance



The immediate aftermath of the January meeting was a drop in the Nasdaq and the start of an increase in the near-term Fed Funds rate. The Composite then tried to rally back to its late January levels, met resistance, and has been sinking ever since. The shift toward a neutral bias by the FOMC sealed the deal. Interestingly, the darker economic outlook signaled by the fall in the Nasdaq has helped price a rate hike out of the Funds rate. This, paradoxically, may help stabilize stocks: Weaker stocks today will keep higher rates away tomorrow.

This is a dangerous game. So long as markets are convinced that economic recovery will be met by a monetary tightening, risk will get priced out of the system and an actual economic recovery will be postponed. The combination of Fed error and trade protectionism was a disaster the last time we tried it, and there's no time like the present to stop the madness.