Forbes

Great Speculations

BUYS, HOLDS, AND HOPES

INVESTING | 5/14/2013 @ 10:02AM | 415 views

Stockman's Analysis Correct But Conclusion Wrong

Marty Leclerc, Contributor

NEW YORK, NY - APRIL 26: David Stockman attends Tribeca Disruptive Innovation Awards on April 26, 2013 in New York City. (Image credit: Getty Images via @daylife)

David Stockman, President Reagan's budget director, has been making the media rounds lately with an outlook so bleak, the sole conclusion is that investors should liquidate all their investment holdings and flee to cash. Though we generally agree with Stockman's situation analysis we believe his conclusion is wrongheaded.

Pretend it is early 1988 and you have seen the future. You foresee that the next ten years will bring European wars and genocide, the collapse of the Soviet Union and missile attacks on Israel by one of the world's largest armies. Back home, your vision tells you that years of political squabbling will shut down the federal government and its debt will double.

Seeing this bleak landscape, what would you have done with your investment portfolio? Would you have bought stocks? Probably not, but kudos to you if you did as stocks doubled twice over the next decade, for a 15%+ average annual gain.

David Stockman would have us believe that not only has he seen the future, based on recent trends, but he knows with certainty its grave implications for the financial markets. Both claims are dubious.

Of course the future is unknowable and making predictions based on a linear extrapolation of recent trends has a checkered history. One of the more famous examples was in 2000 when the Congressional Budget Office determined that Clinton-era budget surpluses would continue. That year the CBO not only predicted perpetual surpluses, they said the national debt would be eliminated by 2010.

Predicting the future is hard simply because it's comprised of too many variables and those variables are never static. We agree with Stockman that the political process is dysfunctional and crooked. Like him we are equally concerned with society's debt load and financial repression by the Fed. But we've been here before.

Our political history is a rogues-gallery of elected officials and big money entities. Today's partisanship and short-sightedness are not new. As broken as the system appears, it does seem to be built for muddling through. As for the debt problem: in the late 1940s national debt as a percentage of national income was higher than it is today. And the Fed's bottom-line response back then was not dissimilar to today's policy: ease debt burdens by having savers subsidize debtors.

Given a set of possible outcomes, it's impossible to know how the financial markets will react. The financial markets, simply put, don't have a linear relationship to reality. Only hindsight narrative makes it appear that they do.

We share Mr. Stockman's caution because it's our nature to be cautious when the markets are as optimistic as they are now. We too fret over what will happen when all the liquidity pumping by central bankers stops. Equally, we are concerned if the pumping doesn't stop. Putting all the "known knowns" together, we conclude holding more cash than usual is a prudent course.

But putting all your money under the mattress as suggested is the wrong thing to do as it has only one assured outcome: having your pocket picked by the Fed's zero interest rate policy. It is a sure path to real wealth destruction over time and the loss of purchasing power, due to inflation.

Instead we'd rather face an uncertain future owning shares of good businesses with strong cash flows purchased at attractive prices. Mr. Market may tell us these shares are worth less at some future point, but for now we would own stocks to preserve and build wealth, in real terms, over time. We know the past, and hope the future proves us right.
