Government Intervention and Market Volatility

By Benjamin Weingarten

Amid the volatility in recent months, investors big and small have struggled mightily to gain a grasp of where the markets are going – in the process a number of them have lost their shirts. So why has the VIX reached levels unseen in its history? The answer is very simple: uncertainty. To understand why this uncertainty permeates the market, we must first look at the system from which it sprung.

Markets are supposed to serve as discounting mechanisms, and reflect in a sense a forecast of the future. Even in good times, I believe it is very difficult for knowledgeable and sophisticated investors to get it right most of the time (as an example, see Warren Buffet over the last year, amongst others). Not only does one's thesis have to be right, but one's timing is also crucial, and to combine these two things is very difficult; there is always an element of chance involved with success. No economic model can factor in everything that affects the economy, including human emotions such as fear and greed. But the market, when unhampered is the most effective and unbiased mechanism to provide direction on the future.

Right now we see fear among market participants as reflected in the widespread liquidation in which investments across all asset classes (with the exception of Treasuries) are getting crushed, regardless of fundamentals. Perhaps this is so shocking to people because we were in a 25-year bull market, in which we forgot that values do not always rise. Some of the growth during this time period was real due to technological advancements, liberalization of markets and financial innovation. A significant amount of it was artificial - false prosperity generated by unnaturally low interest rates which led to a preponderance of investments across all asset classes, and the euphoria that went along with this easy money which served to amplify the size of the false wealth creation.

This is not something new. It is in fact a recurring theme in economic history. Artificially low interest rates generate a boom in which there are bad investments which need to be wiped out in the subsequent bust. There have been booms in tulips, booms in railroad companies, booms in real estate and booms in entire nations. The constant is that easy money incentivizes people to take on more risk than they normally would, causing money to flush into the sector or nation of choice during the given time period. It is only when the poorer investments are liquidated that the markets can return to equilibrium and reflect the true value of assets, laying the ground for new real growth.

This is the way our country functioned for a very long time. Throughout the 1800s and early 1900s, we experienced immense growth due to any of a number of factors, most notably unprecedented advances in technology. By the early 20th century, because of relative free market capitalism the poorest people were able to live better than kings of the past. However, there was not uninterrupted growth. We saw a variety of crises and panics. While they were sharp and painful, the government for the most part allowed the inevitable liquidations to run their course.

The Great Depression however set a precedent in which the government would no longer watch as an innocent bystander when times got hard. Two of the voices on the opposite sides of this argument were Andrew Mellon, Secretary of the Treasury, and President Herbert Hoover. Mellon, a fiscal conservative and laissez-faire advocate argued (though unpopular), at least according to Hoover, that liquidation should be encouraged by the government. Hoover, clearly a big fan of deregulation and the free market said:

> The 'leave-it-alone "liquidationists' " headed by Secretary of the Treasury Mellon felt that government must keep its hands off and let the slump liquidate itself. Mr. Mellon had only one formula: 'Liquidate labor, liquidate stocks, liquidate the farmers, and liquidate real estate'. He held that even panic was not altogether a bad thing. He said: 'It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people'

> We might have done nothing. That would have been utter ruin. Instead we met the situation with proposals to private business and to Congress of the most gigantic program of economic defense and counterattack ever evolved in the history of the Republic. We put it into action…. No government in Washington has hitherto considered that it held so broad a responsibility for leadership in such times…. For the first time in the history of depression, dividends, profits, and the cost of living, have been reduced before wages have suffered…. They were maintained until the cost of living had decreased and the profits had practically vanished. They are now the highest real wages in the world.

> Creating new jobs and giving to the whole system a new breath of life; nothing has ever been devised in our history which has done more for … "the common run of men and women."

It would take the Dow until 1954 to reach its all-time high from 1929.

Yet in the wake of the 25 years lost in the markets, the lesson of the prolonged downturn was lost as well. The legacy of the regulations, agencies and overarching philosophy from this period remained, albeit with a variety of other controls removed during the presidency of Truman. Over the years, the government has consistently intervened during recessions, generally by (artificially) lowering interest rates to reflate the economy. In this respect, the central bankers have been successful in that we have avoided anything reminiscent of the Depression. In more recent times however, besides just starting up the printing presses after pricking the bubbles with higher rates, the government has also encouraged the propping up of failed enterprises, when it deems it necessary or convenient. While there are numerous other examples such as with Chrysler a few decades ago and the Mexican peso in 1994, in recent memory the bailout of the Long Term Capital Management hedge fund set a precedent in which institutions deemed “to-big-to-fail” were bailed out directly or provided aid by the government. This set up a highly dangerous precedent because it signaled to businesses that if their balance sheets were big enough, and if they were intertwined enough in the financial markets, they could reasonably expect to be bailed out were something to go wrong. This moral hazard had begun in the Depression era when large sums of money (as today) were injected into financial firms, various industries gained protection and subsidization and the FDIC was created.

The government decided to bail out Bear Stearns, AIG and Fannie and Freddie, but refused to bail out Lehman Brothers, Wachovia and Washington Mutual. The government injected capital into some of its favored remaining megabanks as well. But once the government gets into the business of deciding winners and losers (a precedent set by the interventions of the past) this undoubtedly causes uncertainty in the market. Right now, the government is effectively doing this in soliciting companies who want to receive cash from the government (and by cash from the government make no mistake about it, this means OUR CASH). Our wealth is taxed, and this money is redistributed to different companies at the whim of a handful of politicians in Washington. If we had always propped up failing industries, than how would we ever have advanced to where we are today? When people started driving cars, there was certainly a lot of upset horse-drawn carriage operators put out of work. Was the cost of their loss of business greater than the benefit of the introduction of the automobile? But alas, this is for another essay.

In addition to determining winners and losers, the government has further led the market astray with its TARP program, which apparently now is getting scrapped. One of the most telling things to come out of this is the fact that John Paulson, famed fund manager who made a fortune off of the subprime debacle swooped in and bought the very securities he had shorted after the announcement that the purchasing and eventual auctioning off of toxic mortgages by the government was no longer going to be implemented. When prices drop to certain levels, prudent investors will buy. This is the silver lining in recessions – overvalued assets become affordable.

One of the governments' other major adventures in the marketplace has been in their temporary bans on short selling. The premise is that institutions were losing significant market capitalizations for reasons beyond fundamentals. This brought more artificial protection especially to the finance sector. The short sellers, already scapegoats now had injury to go along with insult as they were squeezed. Short sellers provide just as valuable a function to the market as permabulls. And if the short sellers really were wrong about the companies they cannibalized, then the people on the other sides of their trades would profit when prices rose. It is a zero-sum game. And of course, while those who shorted financial institutions were socked by the government, what of the people that brought the price of oil down in recent months? Were these people not evil short-selling speculators? The government again picks who wins and loses.

Fundamentally, all of these measures taken by the government have served to lead the markets down a perilous and volatile path. Deciding who to bail out makes it very tough for market participants to determine what they should buy and sell, largely because fundamental valuation and analysis is less important than the swift pen stroke of a politician. Creating programs outside of the markets to try to support illiquid assets undermines the objective signals of markets in which value is measured by the market price. If assets are mispriced, then in the long run the market will make the necessary correction. If the government attacks people who make bets one direction or another, then it shakes the very integrity that the free market is based on. Government intervention alters the way the market would naturally function, and I believe that were it not for the uncertainty regarding this intervention we would have a far more orderly and efficient de-leveraging and liquidation.

If the bull run of the past quarter century is over, and if effectively the last decade has been a lost one, then the best thing that we can do to insure that the following decades are not lost as well is to urge Washington to keep its hands off of the market and let it function as it was intended. Any efforts to resist liquidation will ultimately lead to prolonged pain. We can't have capitalism without profit and loss; without success and failure. Prices determined by markets show us the winners and losers. Capitalism without the rough edges is not capitalism at all. The volatility in the markets today reflects the uncertainty generated by our lack of faith in the very capitalist system that has heretofore provided us with so many splendors.

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