MuhlenkampMethods
For the Intelligent Investor
Answers to questions you may not even know you have.

This Is 20/20

This essay was originally published in Muhlenkamp Memorandum *Issue 12, January 1990. It looks back at the international growth of free-market economies since the 1960s and their effect on America's economic position in 1990. By understanding the past, we can better assess the present and better prepare for the future.*

As a new year and a new decade begin, there is a great human temptation to predict the future. At Muhlenkamp & Company, we don't know how to predict the future, so we don't try. Those who *do* try have proven that they don't know how either, so we don't feel too badly.

We do find it useful to assess the present. An accurate assessment of the present is often the best available predictor of the future. Understanding the past is in turn a key to understanding the present, so while everyone else is telling you how the 1990s will be, we'll review some history to obtain a perspective on where we are today. This risks falling prey to the Lightning Bug Effect, but we'll take our chances.

The Lightning Bug Effect

(Some call it hindsight)

The Lightning Bug is a brilliant bug
but its vision is in the past;
It flies through the darkness
with its headlight on its . . . [posterior].
—Author Unknown

From 1945 to 1968 the United States exemplified the strength of a free-market economy. Other countries (primarily Western European) also utilized free markets, but most were somewhat less free and less successful. U.S. advantages in climate, raw materials, size, and lack of war damage were often the rationale for the differences. During much of this time, the Soviet socialist economy was believed to be improving. Intellectual discussion focused on the rivalry between the U.S. and the U.S.S.R., economically

Muhlenkamp & Company, Inc.
Intelligent Investment Management
5000 Stonewood Drive, Suite 300 • Wexford, PA 15090 • (877) 935-5520 • www.muhlenkamp.com

as well as militarily. Although the United States was obviously ahead, the Soviet Union appeared to be gaining on us. This apparent rivalry was prolonged by the economic problems of inflation and stagnation that the United States experienced in the 1970s, so that by 1979 few people viewed the United States as an unqualified economic success. Meanwhile, economic experiments on the other side of the globe were coming to fruition. Free-market economies in the Far East, particularly Japan and Hong Kong, achieved undeniable success, with none of the natural advantages of the United States.

By 1979, Japan's economy had grown to be a major player on the world scene, and its currency a potential alternative to the U.S. dollar. A combination of yen strength and dollar weakness forced President Carter to name Paul Volcker as chairman of the U.S. Federal Reserve, with a charter to reduce inflation and strengthen the dollar. Thus a U.S. domestic economic policy was dictated by international concerns, an unusual occurrence in the postwar period. Shortly thereafter, Jimmy Carter was himself replaced by Ronald Reagan, as the U.S. electorate responded to domestic economic concerns.

Ronald Reagan's success in reviving the U.S. economy demonstrated that the problems of the 1970s were a result of poor policies, and not endemic to free markets. The continued success of free-market economies in the Far East reinforced this point, as did improvements in Great Britain. In France, François Mitterrand was elected in 1981 as a Socialist, but within a year he had to reverse his policies and move toward free markets.

Finally, as 1990 neared, it became apparent that socialist and communist economies were not improving the lot of their citizenry. Even their governments admitted it. The ruble is acknowledged to be so worthless that the Russian government has reportedly offered to pay its farmers incentives in dollars to encourage them to increase output. Can you imagine the U.S. government offering to pay postal workers in yen? Some U.S. congressmen and a few intellectuals may continue to argue whether Reaganomics and free markets work, but the rest of the world has no doubts!

Today, the majority of Americans believe our biggest competitor is Japan. This means that the contest is economic, not military. Japan is the ultimate example of achieving economically that which it could not achieve militarily. And just as we have been challenged by Japan, she is now challenged by Korea, Thailand, and Malaysia. With a little luck, a decade from now these "Asian Tigers" will in turn be challenged by Poland and other countries of Eastern Europe.

To sum up, today it has been shown that:

1. Free economies work. Socialist economies don't. Free markets are ruled by and provide benefits to the consumer, who also happens to be the worker that Marx talked so much about.
2. Free economies work regardless of natural resource advantages or disadvantages.
3. Growth is not inflationary, although some Keynesian economists still believe that it is.
4. Russia appears to be capitulating. We believe a political reaction will come at some point, but it looks like changes in many areas of Eastern Europe are irreversible.
5. If the United States is not willing to lead the free world economically, others (Japan) are willing and able to do so. U.S. domestic economic policy will continue to be constrained by international markets, much as we've constrained other governments since 1945. It will be much harder for our government to inflate its way out of economic difficulties.
6. Our government's current focus is on lowering inflation (the Fed) and taxes (Congress). For the Fed, this continues the task of the last decade. For Congress, it's a new idea. Senator Moynihan doesn't like President Bush's proposal to lower capital gains taxes (for the "rich"), so he suggested lowering Social Security taxes (for the "working man") as part of an overall package to raise income taxes. But the press (and probably the senator's office) is really only talking about the tax cut side of his proposal. The senator is an intelligent individual and a savvy politician, but someone is going to suggest that we cut capital gains taxes and Social Security taxes and skip any increase in income taxes (I think I just suggested it), and Congress will find that this is what people really want.

Those of you who have been with us for 10 years know, that in 1980, we said that if Reagan could get inflation under control, we would have a good decade in the stock and bond markets. This has in fact happened. Anyone invested in the stock market for the last 10 years has quadrupled his money. More importantly, his purchasing power is up 2.5 times. But no one is celebrating. A pervasive fear exists that we will give it back. We think it's unlikely. The 1980s were a mirror image of the 1970s, when inflation and interest rates ran up, causing very poor returns in the stock and bond markets. We risk giving back the gains of the 1980s only if we reinflate. Today all the pressures, domestic and international, are against it. So we see inflation continuing below 5%. At that rate, current interest rates are fair, and stocks are fairly priced.

Editor's Note

In 1990, inflation was 5%, and Ron called the 30-year U.S. Treasury rates fair at 8%. He expected we would not reinflate (though many thought we would) because the domestic and international pressures were against it. In 2007, in spite of all the unforeseen international turmoil and market fluctuations we've seen since 1990, inflation is about 2% and the 30-year U.S. Treasury rates are 4%–5%. By looking to the past to understand the present, he was able to assess long-term market conditions, because long-term market behavior is driven by economic principles.