

## IS THIS THE REASON?

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We continue to be mystified by the two year upward move in the stock market. Yes, the intervention of fiscal and monetary policy put a stop to the downdraft, but we remain convinced that organic growth is a wish not a fact. By any reasonable valuation method, this market is seriously overvalued. Using the Shiller valuation method, the current p/c ratio is around 24:1. At its present level, this market is at best a sell and at worst a hold. It certainly is not a buy.

As we have commented before, the only reason we can justify such a level is if there is a real change developing in Washington concerning the conduct of economic policy. Please note the following quote from the Forbes article *Towards a New Economic Consensus* by Charles W. Kadlec:

The idea that higher spending and higher tax rates are good for economic growth and job creation is losing its appeal. And that creates an opening for politicians and the American people to listen to the latest academic research and to formulate a new consensus around reducing marginal tax rates and government spending.

Here is the way that I think about it. Government spending and tax rebates do not stimulate the economy because for every dollar government spends or gives away, a dollar had to be extracted from the private sector either in the form of tax payments or borrowing. Academic research indicates that virtually every dollar of a tax rebate is saved. But of course, the government had to borrow the money from somebody. Double entry book keeping tells us that for every dollar of tax rebate put into the economy, there had to be a dollar taken out of the

private sector in the form of additional savings used to purchase the newly issued government debt.

For example, some people put their \$300 rebate into a savings account. But the bank, in turn, used that money to invest in newly issued Treasury securities instead of making loans to local businesses. Or, if the government debt was purchased by non-U.S. residents, then this capital inflow had to be financed by reduced purchases of American goods and services by foreign entities, or lower levels of investment in the private sector.

Therefore, the net cash flow into the economy from government spending or tax rebates is zero--nada, nothing, zilch. In other words, government spending does not and cannot increase demand in the aggregate. It simply crowds out private sector activity. Generally such spending also raises current or future tax rates. Both results decrease our liberty and prosperity.

By contrast, tax rate reductions lead to higher economic activity, not because they put money in peoples' pockets, but because reducing tax rates lowers the barriers to domestic commerce. Income and sales taxes are the precise equivalent of tariffs imposed on domestic trade or economic activity. When you increase tariffs, less trade occurs. When you lower tariffs, more trade occurs.

The full article can be found at <http://www.forbes.com/2011/01/03/taxes-economics-spending-opinions-contributors-charles-kadlec.html> and we would encourage you to read it if you have the time.

If we can elect people who understand that supply creates its own demand and not the other way around, then maybe, just maybe, the surge in stock prices makes sense.