Drobny Guest Research

March 8, 2010

3701 Highland Ave, Suite 302 Manhattan Beach, CA 90266 andres@drobny.com (310) 545-6995

Ahhh, the 1931-32 scenario. In Tim's piece below, it comes from a popular uprising. And, he's absolutely right that a premature withdrawal of fiscal stimulus could well push the world economy back towards the abyss. Yet, beware the law of unanticipated consequences. Sure, a popular backlash to bailouts may lead to an era of austerity. But, they can also take us on a rather different route. In some circumstances, admittedly more often in inflationary rather than deflationary episodes, popular revolts have resulted in political coups, military regimes, wars, and other big changes that sometimes led to more government involvement and economic activism, not less. Yet, it also happened in deflationary times: remember the theory that the demand thrust from WWII that allowed the world to overcome the forces of the Great Depression. - *Andres Drobny*

The Dawn of an Era of Austerity

Tim Rustow

Maple Leaf Capital

The hyper-Keynesian response to the recent sharp recession was the logical conclusion of a 22-year drift and then acceleration from the Reagan/Thatcher revolution and the so-called Washington Consensus. Maybe it all started with the Mexican bailout but wherever it began, the bailout option has come to an end – there is no one with the balance sheet to rescue the West. If the rate of government debt accumulation cannot be increased, then the hyper-Keynesian response is no longer an option.

The ascendancies of Reagan and Thatcher were, in economic terms, a populist revolt against the tax and spend policies of the late 60's and 1970's. The will and the mandate to cut the size and the scope of government were short but powerful. The peak of this philosophy in action was the U.S. Tax Reform Act of 1986. The last gasp was the Clinton-era welfare reform. The size and scope of government has been accelerating ever since. Once the economic downturn struck, the solution suggested by modern day supporters of Keynes was more government spending and deficits. Even the Bush tax cuts in response to the 2001 recession was an effort in Keynesian "pump-priming" (hence the sunset provision). By the time we faced the possibility of another depression in 2008, we all became Keynesians - Hyper-Keynesians as fiscal and monetary restraint was almost completely thrown off.

If the Tax Reform Act was the policy peak of the prior policy revolution to reform and reduce the scope of government, the Obama administration's $787bn "stimulus" package was the peak policy moment for Hyper-Keynesianism. While there might be more reckless spending bills and bailouts coming in the months and years ahead, nothing of that size and nature is likely to happen again in the West. Savers, earners and markets are beginning to revolt. In this regard, the election of Sen. Scott Brown in Taxachusetts was the shot heard round the world. ***Was it a mere coincidence that major equity markets peaked the day before the election?*** Do they sniff the fiscal spigot being slowly turned off? A similar revolt seems to be taking place in Europe as Germans seem reticent to pick up the tab for Greece's embarrassing fiscal profligacy. Hence the increased machinations by pro-bailout German politicians to avoid parliamentary approval.

Record post-war budget deficits and GDP/debt ratios in much of the West have reached the limit of their growth. In this respect, the current Greek crisis is but a warm up act for the larger crisis yet to come. Because the markets will no longer finance Greece's debts, Greece will undergo a massive contraction in economic growth, wages and asset prices. Without the option of devaluation and default there is no way for Greece to escape deflation. Crucified on a cross of Euros.

If serial bailouts and fiscal expansion are tools that are no longer available to policy makers, the era of Hyper-Keynes is dead. No one is a Keynesian now – out of practicality if not ideology. What will replace it? Markets and the public will increasingly demand primary budget surpluses, fierce public sector wage and job cuts, and other policies designed to bring the West's fiscal situation under control. The switch from fiscal expansion to fiscal contraction will be a sea-change for the global economy. In this new atmosphere, even the ability of central banks to pursue unconventional monetary policy might be hamstrung. None of this will have a salutary effect on asset prices.

Tim Rustow
Tim@mapleleafcapital.com

Drobny Global Advisors, LLC is an independent research firm. This report is provided solely for informational purposes. It is not intended as an offer to buy or sell any instrument or security nor as advice or recommendation to participate in any particular trade or trading or investment strategy. The content of this report is based on or derived from information generally available to the public from sources believed to be reliable. No representation or warranty, express or implied, is made as to the accuracy or completeness of such information. Past performance is not an indication or guarantee of future performance and no representation is made regarding future performance. Opinions expressed in this report may be changed without notice and may be inconsistent with, and reach different conclusions from, prior or subsequent reports. This report may not be reproduced or redistributed to any other person, in whole or in part, without prior written consent from Drobny Global Advisors, LLC.

This report does not consider the specific investment objectives, financial situation, or particular needs of any specific person, fund or institution. Accordingly, recipients bear responsibility for their own investment research and decisions and should seek the advice of qualified advisors, and perform their own due diligence, before making any investment. From time to time, Drobny employees may trade for their own accounts in markets covered by the Drobny Global Monitor. Additionally, guest research pieces written by outside parties may describe trades, trading strategies or investment products in which the authors or their firms have or intend to acquire positions.