

How Politics Relates to Economics

THE COINCIDENCES IN LIFE ARE AMAZING.

I was a young economics student when the Soviet Union began to collapse, and it was fascinating. We had a visiting professor from Moscow teach a class on the economics of communism, which was one of the best classes I took in college. I was so fascinated that I accidentally ended up with a minor in international studies. During my last semester I did an independent study on how former Soviet states should transition from the command economy to a free economy. I argued that they should follow the Polish model, which, put simply, was the rip-the-Band-Aid-off approach. My professor did not like my conclusion, but history did, and that explains why I pursued a career in investment management over academia. In my world one gets rewarded for being actually correct, versus politically correct.

In my early career this focus was little more than an interesting talking point. It certainly did not help me get my job at Invesco. Then one day, almost a decade after writing that paper, my boss stormed into my office and told me that I was going to Poland. What are the odds?

I arrived in Warsaw in January. (Even people of Polish decent don't travel to Warsaw in January.) The manager of the Warsaw office took it upon himself to be my tour guide. He took me to the old part of town, which looks like a lot of old European cities, and explained it was actually a source of embarrassment for many Poles because it was a replica. The Nazis had destroyed Warsaw, and what I saw had been rebuilt.

My tour guide had been a young boy during that period, and we discussed what it was like to be under Nazi occupation. He was defensive about the atrocities which took place in Poland in places like Auschwitz. People today think they could have stood up to the Nazis, but that is much easier to do in the safety of history class; it is a little different when you fear for your own life.

He remembered being liberated by the Soviets. Everyone in Warsaw celebrated at first, but then they transitioned to communist rule. I asked him how the Nazis and Soviets

differed, and with tears in his eyes he said, "The only difference was who they chose to murder." Our modern perception is that the extreme right and the extreme left are opposites, but the truth is they are the same; they were then and they remain so today. We then drank a toast to Lech Walesa and the Solidarity movement that allowed him to be showing his city to his new American friend.

It was refreshing working in Poland. No one appreciates economic freedom more than those who know firsthand what it is like not to have it. They knew full well how fragile freedom could be – a lesson we seem to have lost in modern America.

As with so many subjects which should simply be what they are, economics has become politicized in our modern world. The perception is that people on the right are for capitalism, whatever that means, and people on the left are for socialism. It reminds me of a George Will column in which he made the argument that young people claim to like socialism because they like being social, and that is what they think it means.

I have no idea how they teach economics today, but when I was a student we did not use the terms capitalism or socialism, which I believe is for the best if one really wishes to understand the economic spectrum.



Two ends of the economic spectrum – Hong Kong during British rule (Free) to the former Soviet Union (Command)

On one end of the spectrum we have a free economy, which is an economy with no government interference; on the other end we have a command economy, which is completely controlled by a governmental central power. This is the spectrum.

In the modern world the closest we have probably gotten to a free economy would have been British-controlled Hong Kong. There were very few rules and regulations, and as a result it became the business center for much of Asia. Pulitzer Prize winner Milton Friedman discussed Hong Kong's success in his

book co-authored with his wife, Rose, “Free to Choose.” It was his favorite example of the power of freedom in the economy.

The closest we have come to a true command economy was the Soviet Union. Everything in the Soviet Union was controlled by Moscow. However, even in the days of Stalin, it is nearly impossible for the government to control everything as people will find a way. There was a significant black market in the former Soviet Union.

In reality, most economies exist somewhere along the spectrum between free and command. Our system in the United States has always tilted closer to being free. How free our economy should be – or, put another way, how limited the role of government should be – has been hotly debated throughout our history.

That this debate fits neatly along partisan lines is, however, a myth. The political spectrum, unlike the economic spectrum, is a circle, not a line. Understanding why would take far more space than this newsletter avails, but history tells us this is the case. If one starts with a free economy, it matters not which way she turns politically. She can go right or left, and either way, she will eventually end up in a command economy.

For the first half of America’s history we were pretty close to being a totally free economy. The 19th century was a time of great economic growth and expansion, culminating with the “Gilded Age” as enormous fortunes were gained, and lost. The average annual wage of an industrial worker rose 59 percent in the decade from 1880 to 1890. However, there were also significant recessions. The Panic of 1873 and the Panic of 1893 caused great concern. The financial crisis in 1873 was known as the Great Depression until the crash of 1929 and the decade of the 1930s usurped that title.

While great wealth was produced, the era of the so-called robber barons saw industries monopolized. America started taking steps towards a command economy as antitrust laws sought to break up monopolies and create a more even playing field. In Europe, economies moved even further towards command as the philosophy of Karl Marx and Friedrich Engels became widely adopted. Economists like John Maynard Keynes sought ways to preserve the free economy against the Marxist ideology by trying to smooth freedom’s rough edges.

Governments could use government spending to ease the suffering of recessions. Later economists like Milton Friedman argued that interest rate policy was more effective than government spending. In addition, countries adopted social safety nets to help those in poverty. These things were done with good intent to preserve what was so good about a free economy.

In Europe it mattered little if one was occupied by far-right Nazi Germany or far-left Soviet Union; the outcomes were the same. Over 100 million lives were lost to the two great evils of the 20th century, and the one thing they had in common was the command economy. Is that a coincidence? Friedrich Hayek didn’t think so, and he had some knowledge, having a front-row seat to the rise of fascism. His conclusion that concentrating that much power in government will eventually lead to a tyrant taking power fits both logic and history.

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The 3rd quarter 2024 GDP growth came in up 3.0 percent, which was better than we expected. GDPNow shows 3.2 percent growth in the 3rd quarter. The economy just keeps rolling along despite all the doomsayers.

The official unemployment rate was 4.1 percent through September.

The labor market remains strong. After a slight rise in unemployment the rate has leveled off. We seem to show that we are in the middle of the economic cycle and not near the end.

Inflation is 2.5 percent based on the latest consumer price index report. The slowdown has predictably gotten slower, but we are approaching the 2 percent target. The producer price index, which tracks wholesale prices, is up only 1.7 percent over the last 12 months. +

REVIEW of ECONOMY

The market produced a broad-based rally.

For the quarter the S&P 500 finished up 5.89 percent, and small company stocks represented by the Russell 2000 index were up 9.27 percent. Value dominated with the Russell 1000 Value index up 9.43 percent while the growth index was up 3.19 percent. For small companies the difference was much less with the value index up 10.15 percent, and the growth index was up 8.41 percent.

Bonds were up big.

The Bloomberg U.S. Aggregate Bond index ended up 5.20 percent. High yield bonds rose 5.28 percent. Bond yields dropped to the lows of their range.

International stocks were also up. The EAFE index finished up 7.33 percent and the MSCI Emerging Markets index ended the quarter up 8.88 percent. +

REVIEW of MARKETS

MARKET forecast

We said the market had to broaden out and it did. This trend should continue. It may go in fits and starts, as it already has this year, but the valuations tell us we still have a long way to go.

AI-driven technology still has legs, so while tech may underperform it should still deliver positive results. International remains attractive from a valuation standpoint and the European economy is hanging in there. We should continue to see outperformance from overseas.

Bond yields ended the quarter near the bottom of their range. That will likely bode ill in the very short-term, but longer-term bonds look fine in this range around 4 percent yield. +

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The United States of America went down the path of Keynes and then Friedman, maintaining our free economy while using government policy to smooth the rough edges. We also were the hero of that century; we seem to have forgotten that with all of our flaws, we were still the good guys who helped our Allies defeat the extremism of both the right and the left.

Our challenge is one of nuance, and unfortunately we are not very good at nuance anymore. It was good that we broke up monopolies and helped people with a hand up during time of economic distress. But how far down the road towards the command economy becomes too far?

As in Europe, it matters not if we go to the left or to the right. John F. Kennedy was a man of America's left, but he believed in the power of a free economy. Ronald Reagan was a man of America's right, but he too believed in the power of a free economy. Lydon Johnson was a man of the left who believed in the command economy, followed by Richard Nixon, a man of the right who believed in the command economy. Jimmy Carter, a man of the left, started our move back towards freedom.

After Reagan, George HW Bush held us steady and so did Bill Clinton – a man of the left who said Reagan was right and, “the days of big government are over.” If only George W Bush had listened. W, a man of the right, moved us well down the path towards command. Barack Obama, a man of the left, campaigned on change, yet the only economic change he made was to push down hard on the gas pedal and get us moving even faster in the direction in which W had first turned us.

Donald Trump, in his first administration, moved us back towards a free economy and got the good economic results that Americans my age expect, but younger Americans didn't know were possible. Joe Biden reversed all of that, and here we are today. What will the next administration do? Their

track records suggest that Kamala Harris will move us even further towards government command of the economy and Donald Trump would do the opposite. However, Harris keeps flip-flopping on all of her positions and Trump is talking more like a big-government command guy than he did eight years ago. It is hard to know.

I can tell you this: It is policy that matters. What do they actually do? It matters little what color jersey they wear. Modern politicians don't lead, they follow. They do what they think the voters want. Did Bill Clinton really believe in deregulating banks? I have no idea, but in the 1990s that was popular and he did it. Did Trump really believe in Paul Ryan's tax and regulatory reform plan? I don't know, but it was popular, and he did it. All the economic success of his pre-Covid term was driven by it. We get the government we demand. It is up to us.

At the margins, all of this simply leads to better or worse economic conditions. However, today there is a lot of talk about extremism on both the left and the right. Much of that is hyperbole, but to the extent that it exists, we should all remember what my Polish friend witnessed: the only difference between the extreme left and the extreme right is who they choose to murder. The 20th century was the era of the command economy. It was also the bloodiest century in human history. We would do well to remember that. The free economy is about a lot more than just maximizing growth. So, no matter if you are of the left or the right, we need to all do our part to keep our respective political sides moving up towards freedom.

Warm Regards,



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