"Obama to push for federal pay freeze"

-*Financial Times*, November 20, 2010

We must truly be living in extraordinary times. We try to keep our investment decisions free of the hustle and bustle of politics. More often than not, politics are a distraction from the underlying factors that matter most, such as demographic trends and valuations. But today, we can't avoid discussing politics because so much of the market's action over the past three years has been driven by (or at least seriously influenced by) decisions made in Washington DC: bailouts, TARP, quantitative easing, health reform…name any major factor that has been driving asset prices, and chances are good that it came from the halls of government, either domestic or foreign.

This is why I find President Obama's recent decision to be truly extraordinary. Mr. Obama, for better or worse, is a strong supporter of the labor movement and of an active, energetic government. His decision to freeze pay of federal workers is in direct contradiction to both of these.

Perhaps it is a "Nixon in China moment", just as it was said that only an anti-communist hawk like Richard Nixon could make the politically-difficult decision to recognize Red China, perhaps only a liberal progressive like President Obama could make the politically-difficult decision to slow the growth of the Federal Government. Of course, his decision to do so was most likely spurred by his party's loss in the mid-term elections. But would a republican in the White House have been able to make the same decision without triggering mass strikes by Federal workers? Of course, we'll never know, but the answer is probably "no."

As investors, the relevant question to ask is "what does this mean for the markets going forward?"

Unfortunately, that is a tough question to answer. Austerity at the Federal level should mean a slowing in the economy until the private sector recovers well enough to pick up the slack. All else equal, this should be good for bond prices but bad for stock prices.

Of course, "all else" is not equal. Fed Chairman Ben Bernanke is attempting to pick up the slack in Federal fiscal stimulus by replacing it with monetary stimulus—i.e. quantitative easing. All else equal, the Fed's actions should stoke inflation, which would ultimately be bad for bonds but *could* be good for stocks in the short-term.

Again, "all else" is not equal. Credit continues to be destroyed by the private sector faster than it is created by the Fed, meaning that deflation is still a bigger risk than inflation. This is *good* for bonds and *bad* for stocks.

Suffice it to say, there are a lot of countervailing forces at work, though the evidence suggests that the economy is improving, little by little. At this stage of the game, it is impossible to say how things will shake out.

For now, we as investors have to maintain a level head, keep our emotions in check, remain flexible and take advantage of investment opportunities as we see them.

Sincerely,

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