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INSIDE STORY

Ignorance Is Bliss. *Or Is It?*

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Ignorance Is Bliss.

There has been a great deal of volatility in the market over the last quarter, and I believe much of it is driven by pure ignorance.

I came up with this theory when I saw an article written by Daniel Klein, professor of economics at George Mason University and editor of *Econ Journal Watch*. Klein's article was about a survey done by Zogby International measuring basic economic understanding. Of the eight questions, people who identified themselves as "progressive/very liberal" were correct about basic economic questions only 34% of the time. A third of them did not understand what it meant to have a monopoly. People who described themselves as "very conservative" did best, scoring an 83% on the test, followed by libertarians, who scored 82.75%.

When one sees these survey results from an organization as widely respected as Zogby, it should make one ask, Does this have anything to do with Europe falling apart? Could the crisis in Greece be a byproduct of the far left being blind to economic consequences? Throughout the world today we see a strange confluence of events: leftward-leaning economies collapsing and a backlash against private enterprise.

I know it is always dangerous to bring up politics, and we certainly do not mean to offend, but as I have said before on these pages, there are plenty of things about which Democrats and Republicans, liberals and conservatives can legitimately disagree, but the general direction of economic policy is not one of them.

I think Bryan Caplan explains it magnificently in *The Myth of the Rational Voter*. Caplan points out that the vast majority of voters are economically illiterate, which explains why American "politics" so frequently devolves into divisive social issues like abortion or gay marriage. How many times in the last twenty years has Congress voted on abortion legislation or a gay rights bill or any other social issue that takes up so much of our political air? Compare that to the daily decisions being made that impact economic policy. Industry regulation, appropriations, taxation – these are the daily business of government, and unfortunately they are ignored until we end up at the place we are today.

Political scientists and economists have traditionally believed that the average voter had no real idea of the economic consequences of his vote, but that these errors were random. So while the economically educated were a small minority of the voters, the belief was that their view would win the day because the economically illiterate voters cancelled each other out. Caplan argues, convincingly, that this is not true because the erroneous views of the masses are in fact not random, but systematic. Most people do not just have random misconceptions about economics that cancel each other out at the election box, but in fact they have the same misconceptions that end up swaying elections in favor of sometimes very damaging economic policy.

Caplan identifies four basic biases that the vast majority of people share, all of which lead to undesirable policies. Those biases are: 1) anti-market, 2) anti-foreign, 3) make-work, and 4) pessimism.

Let's start with the anti-market bias. Most people simply do not understand the "invisible hand" of the market and its ability to harmonize private greed and the public interest. This has certainly been true over the last few years during the financial crisis. There has been much blame placed on the market, even though the facts of the case clearly show failures of government policy and regulation. We speak of these failures often as the "unintended consequences" of well-meaning policies.

Greece, for example, paid its public employees 14 months salary for every 12 months worked. They provided full retirement benefits at age 50, and covered all medical expenses. When all is well, the vast majority of voters would be in favor of such bountiful benefits. Unfortunately, these generous gifts come with an unintended consequence: Greece is now broke.

It is important to see that while these results may have been unintended, that does not mean they were unforeseeable. Governments do a far worse job of making economic decisions than does the mysterious power of the market. History if full of such examples.

Twenty years ago the greatest example of all presented itself. The collapse of the Soviet Union, combined with the economic success of the pro-market reforms in the US and the UK, put an end to what had been a debate about how to best run an economy. Bill Clinton declared

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the days of big government to be over. Yet somehow this poisonous idea that government regulation is superior to free market forces survived only to resurface today.

I want to be clear here. I am not saying – nor was Caplan – that conservative economists or economists from the 'Chicago School' have more faith in the market than the average lay person; I am saying that the consensus view of all economists is more favorable to the market. John Maynard Keynes himself was a true believer in the free market and did not believe in socialistic government regulation or control of the economy. In his own words, "Marxian Socialism must always remain a portent to the historians of Opinion – how a doctrine so illogical and so dull can have exercised so powerful and enduring an influence over the minds of men, and, through them, the events of history."

There are differences of opinion among economists, and some views are closer to being what Caplan calls 'market fundamentalist' than others, but these differences are far smaller than the general public realizes. In his book, Caplan tells a humorous anecdote from the Carter White House. Even in the Carter administration, the economic advisors were economists first and liberals second. A policy adviser asked the economic team to prepare the best economic arguments for a particular policy, and the response was that there is no economic argument for this policy. The policy staffer shot back that he understood that the economic advisor may not completely agree with the direction of the administration, but he needed to be a team player and give him the best known economic arguments. The economists replied he was not trying to be difficult, but there really are not any economic arguments in favor of the policy in question.

This kind of thing is still happening today. The Brookings Institute issued a white paper a few years ago about the problems in our health care system and what policies should be adopted to solve them. One of their conclusions was that patients do not bare enough of the cost of their care, which causes two issues. First, there is greater demand for health care services because the patient is not the one paying. Secondly, the patient gets worse service because the health care provider is actually getting paid by – therefore works for – the insurance company. The solution suggested was more old-fashioned reimbursement-type insurance plans, greater use of health savings plans, etc. Some of the authors of this paper have consulted the Obama administration, but the actual legislation went in the opposite direction. There is near unanimity among economists that the unintended consequence of this legislation is that health care costs will skyrocket.

With financial reform regulation, it has been the administration's own economic advisers pushing back harder on the left's proposals than even the republican opposition. As I am writing this, there are warnings that some of the requirements of this bill will do away with the free checking that almost everyone in today's banking system enjoys, and potentially an entire class of people will not be able

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REVIEW *of* ECONOMY

Where did the recovery go? GDP growth for the first quarter was revised down to 2.7% and is expected to be slower in the second quarter. This is lower than past recoveries and forecasts for future growth continue to get revised downward – not a good sign this early in a recovery.

Unemployment remains a big issue at 9.5%, and while that represents an improvement in the headline number, it is only from people giving up and dropping off the rolls. The recovery is stalling out and with no improvement in the job market it will not feel like there is any recovery at all.

The actions of our policy leaders continue to surprise and alarm us. This quarter there was continued bashing of corporate America by our leaders in Congress and the administration. First they ganged up on Goldman Sachs and then on BP. Granted these entities are far from saints and may be deserving of reprimand, but the amplified anti-business rhetoric and threats to "kick someone's ass" are reverberating far beyond these headline companies. The business community will not begin to expand and thereby hire new employees until these thuggish tactics cease. +

REVIEW *of* MARKET

It was tough quarter. The S&P 500 was down 11.43%. Keep in mind, however, that this is the first real correction we have had since the market took off like a rocket in March of 2009. We were overdue for a pullback, and we got one. Although the economic data is weak, we think corporate earning will remain stronger than expected and that the market will march forward in the second half of the year.

Treasuries had some life pumped into them as the dept crisis in Europe saw investors seeking quality. High yield bonds were basically flat for the quarter. We still think the smart move in fixed income is in corporates and high yield for the longer term. +

MARKET *forecast*

We remain fairly optimistic about the markets' chances in 2010, as corporate profits should continue to grow even as the recovery slows. We are sticking with our 12% forecast for the S&P 500 even though it looks more at risk than it did three months ago. We still like domestic over developed international, although stock prices in Europe are beginning to look like they have baked in all the troubles.

The long-term emerging markets story remains in tact, so we are maintaining our overweight. We have removed our overweight to small caps as the lackluster recovery benefits stronger, larger companies.

We continue to be concerned about the bond market. Treasuries seem like a trap right now. Corporate and high yield bonds are looking fully valued. We proceed with caution in what is supposed to be the safe areas of the market. +

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to obtain a bank account. This is another unintended consequence, but it is not unforeseeable.

Now for the anti-foreign bias: there is an unexplainable bias against free trade among other nations and a fear of immigration. People tend to see other nations as competitors instead of partners in a global economy. In his book *Pop Internationalism,* Paul Krugman states, "The growing obsession in the most advanced nations with international competitiveness should be seen not as a well-founded concern, but as a view held in the face of overwhelming contrary evidence. And yet it is clearly a view that people very much want to hold – a desire to believe that is reflected in the remarkable tendency of those who preach the doctrine of competitiveness to support their cases with carless, flawed arithmetic."

The fact is free trade is an economic win-win for all nations, and legal immigration is desirable as immigrants usually take jobs that, for whatever reason, native workers do not want. Immigrants also can bring with them skills and knowledge that the native workforce may not posses. No country is a greater example of this power than the United States, yet the majority still believes trade and immigration to be harmful, and populist politicians, mainly on the right, take advantage of this fear. The protectionist actions of the Obama and Bush administrations have led to many unintended consequences, including double-digit unemployment. It has also contributed to part of our health care issues.

International travelers may have wondered why a Coke in Great Britain tastes so much better than a Coke in Atlanta, the home of Coke. In Great Britain that Coke is sweetened with real sugar, as opposed to high-fructose corn syrup in the U.S.. Experts have argued that the use of high-fructose corn syrup in the US is contributing the obesity epidemic. So why do U.S. food manufactures use high-fructose corn syrup? Because here in the U.S., we pay more than twice what the rest of the world pays for sugar. Sugar beet farmers must be protected, so sugar from far more efficient sugar cane farms around the world must pay a heavy tariff to enter our shores.

The public also has a bias towards make-work programs. As we talked about in length in previous newsletters, economic growth brings much better jobs, but that is not the belief of the masses. Politicians promise job programs, and even brag about the jobs they have created while the unemployment rate is held below 10% only by the hordes of workers who have given up hope and dropped off the rolls.

Finally, people also are more pessimistic about the economic future than are trained economists. Maybe here is the silver lining. My first micro-economics professor in college opened class the first day by making a bold statement: The economy is more powerful than any President or any Congress. I'm not sure I believed him at the time, but I do now. Our current administration has seemingly done everything in their power to harm the U.S. economy, yet it still grows. We are growing far slower than we have in any other recovery, and far slower than we would be in more competent hands, but even so, the economy is coming back. This too shall pass, the pendulum will swing back, and we will see economic prosperity again in the U.S..

Ignorance is supposed to be bliss, but if Mr. Caplan's data is correct, it looks like the knowledgeable are actually far more optimistic. That isn't a bad thing.

Chuck Osborne

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