

 WILEY Trading

TRADE THE CONGRESSIONAL EFFECT

**How to Profit from Congress's Impact
on the Stock Market**

Eric T. Singer

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Trade the Congressional Effect

*How to Profit from Congress's Impact
on the Stock Market*

ERIC T. SINGER



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To my loving wife, Aet, so beautiful, so patient, so wise.

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Introduction

“Government is not reason, it is not eloquence. It is a force. Like fire it is a...dangerous servant and a fearful master, never for a moment should it be left to irresponsible action.”

— George Washington

“Government is not the solution to our problem... Government is the problem.”

— Ronald Reagan

Who would have thought in the 1990s that by the end of 2011 we Americans would have had a lost decade in which our investments were shattered, our equity in homes would disappear, our 401(k)s would be cut in half, and our stature as the preeminent economy of the world would increasingly be called into doubt? The convulsions of the past decade have resulted in economic and social setbacks of epic proportions. Our standard economic remedies have been tried and tried again, but now seem impotent against the giant new challenges facing us.

We have arrived at this surprisingly desperate moment after 100 years of slow but relentless growth in—and dysfunctionality of—government in general, and Congress in particular. Our politicians have engaged in magical thinking for so long that the magic is gone. They actually believe they can, like Harry Potter, speak incantations and create jobs and prosperity for everyone. But unlike Hollywood special effects, there are no economic or political spells that can dispel our troubles. We are in a mess caused by our own willful abandonment of our core principles. The remedies we used to believe in no longer work.

The public already knows something is very wrong but can't quite put its finger on what it is or, especially, what to

do about it. As of February 2012, Congress's approval rating is 10 percent, according a Gallup survey,¹ below its former all-time low in the crisis of October 2008, when the equity markets were plunging, on their way to a frighteningly sudden 50 percent loss in less than nine months. In fact, out of 16 major institutions, such as the military, the police, and so on, Congress now ranks dead last.

Congress would have us believe that every little morsel and crumb we receive is dispensed to us by a gracious government that has changed the social safety net into a pampering spa, and that if we don't let Congress continue to dispense us goodies, we will have nothing. But we should not want the government to do us any favors. When it looks into our wallet and finds a 10-dollar bill, it immediately takes credit for those 10 dollars. But government can only subtract value, it cannot create value. This subtraction of value is what I call the Congressional Effect.

This book provides a new, empirically objective way to understand day by day what our government takes away from all of us. It shows in hard numbers what we lose out of our wallet when Congress acts. Knowing exactly how much poorer we are because of relentless government bloat, this book suggests concrete investing strategies to make Congress's systemic dysfunction work for you, and to hedge the risk and the damage that Congress so casually and relentlessly inflicts on your life savings as represented by your portfolio and your house.

Our Damaged Economy

In the past 10 years, the U.S. economy has suffered one disaster after another, all of which were predictable and many of which were avoidable. In the 1990s it would have

been inconceivable to think the following would have occurred by the end of 2011:

- That the government, in the name of “affordable housing,” would use Fannie Mae and Freddie Mac to force banks to lend to a wider pool of people, thus creating a giant credit bubble.
- That the credit bubble would in turn inflate housing prices to unsustainable levels, which in turn set up the housing collapse.
- That the housing collapse would be so massive that it would wipe out a third of the average net worth of every American household, with the value of the housing stock falling on average by 33 percent from its peak,² and with roughly 29 percent of homes with mortgages upside down³ (where the balance owed exceeds the value of the home).
- That the collapse of housing prices would end housing's role as a store of value.
- That families would move in with each other out of economic necessity, ending 200 years of household dispersion and threatening 20 million houses (and their associated mortgages) with abandonment.⁴
- That there would be a record 12 percent of all mortgages in default or in foreclosure in 2009,⁵ representing over 5,400,000 homes.⁶
- That Fannie Mae and Freddie Mac—notwithstanding their role in all of the above—would be the *only* financial entities to escape significant reform in the comprehensive Dodd-Frank reform law.
- That Lehman Brothers, Goldman Sachs, Morgan Stanley, Citibank, Merrill Lynch, and other major investment banks would be allowed to leverage their debt to over 30 times their equity by 2007, up from 12 times in 1999, setting them up for having their equity wiped out when

the market experienced an epic collapse in 2008, and requiring massive bailouts from the government in 2008 to stay in business.^{[7](#)}

- That the collapse of these institutions would result in the Federal Reserve's accepting their mortgage paper, thus finding itself with \$2.8 trillion in questionable assets and liabilities by the end of 2010,^{[8](#)} against equity of \$50 billion, resulting in leverage of over 56 times by the end of 2011, just when the economy looked like it might reenter recession.
- That the Fed would begin to print money like crazy, euphemistically calling its program “quantitative easing” (that is, the nominally independent Federal Reserve, which has its top executive appointed by the president and is subject to congressional review, buys Treasury bills and bonds from the United States Treasury, but insists that no money has been printed, even though there has been a tripling of the money supply).
- That the Federal Reserve would, as Bill Gross of PIMCO puts it, “financially repress the savers of this country”^{[9](#)} by effectively offering no return on their capital in order to keep short-term interest rates fixed at zero.
- That the Federal Reserve would use the moment when our credit rating was deteriorating to shorten rather than lengthen our liabilities, giving us less room for error should the other nations decide they no longer want to purchase our debt.
- That a return to the prevailing interest rates of five years ago of 5 percent^{[10](#)} would require the United States to pay \$750 billion per year^{[11](#)} just to service our debt, an amount equal to 27.5 percent of our 2007 budget.^{[12](#)}
- That we would be borrowing 43 cents out of every dollar spent by the federal government in 2011.^{[13](#)}

- That the exploding regulatory regime would create a drag of \$2 trillion¹⁴ on our economy and enormous destabilizing forces in each sector of the economy.
- That the government would put both enormous deflationary and inflationary forces into the economy at the same time, without any understanding of how much they could undermine faith in the future and job and new business creation and with no concrete understanding of which force would prevail.
- That the government would ignore two centuries of established bankruptcy law in the GM and Chrysler bankruptcies to favor unions over creditors, a high-profile example of the ongoing erosion of the rule of law, which in turn would cause consumers, investors, banks, and business to freeze at the switch in a deflationary offset to all that money we have created.
- That the Congressional Budget Office would maintain a nominally cash-based, time-limited, formalistic analysis of our budget as the basis for discussing our future, when such accounting would be outlawed in the private sector.
- That the American consumer would be retrained to consider strategic default on debt a viable option.
- That the median household would lose half its retirement savings.
- That by 2011, the average U.S. household real income would fall to levels below those of 1996,¹⁵ wiping out 15 years of financial progress.
- That we could have a several-year period when the official unemployment rate could stay at what was once considered European levels of about 10 percent, and that more than half those laid off would be out of work over a year, with their jobs skills and careers irreparably damaged.

- That the number of people on food stamps would reach 46 million.[16](#)
- That enormous amounts of additional transfer payments would be orchestrated, including a vast food stamp program, free health insurance for the poor, extending unemployment benefits to 99 weeks, expanding Medicaid and Medicare eligibility,[17](#) all with the perverse effect of reducing confidence in the economy, not enhancing it.
- That the amount of transfer payments each year would exceed all the money raised from income taxes—leaving no way to pay for defense or interest on the national debt without borrowing heavily from our potential enemies abroad.
- That Congressional innumeracy and unrestrained profligacy would strongly contribute to gold's rising from \$290 per ounce in 2000 to a high of over \$1,900 an ounce during 2011 and 10% deficit spending.[18](#)
- That the U.S. government would resort to serial staggering but impotent stimulus efforts, adding over \$5 trillion of unnecessary and unusually unproductive excess spending, and as result borrowing an extra \$5 trillion, which was in turn added to the national debt,[19](#) all in the name of creating jobs, but in fact having the exact opposite effect of destroying jobs.[20](#)
- That the General Accountability Office would not be able to issue an audit opinion on the 2010 financial statements of the federal government “because of widespread material internal control weaknesses.”
- That as a result of this excess spending, the debt of the United States would be downgraded for the first time since formal credit ratings began in 1917. Not all of these disasters were the direct fault of Congress. But by

the summer of 2011, it had become clear that the governance of our nation had unalterably changed.

For three years in a row, the Senate ignored the 1974 Budget Act and did not even pass a budget, ashamed of the scrutiny it would bring. But that shame did not translate into slowing down the legislative process when Congress wanted to be reckless. For example, the Senate and the House both were able to pass two laws: health care reform and Dodd-Frank, each with over 2,000 pages and less than 72 hours to read them before passage. The 2010 House of Representatives did not pass a budget either.

In 2011, instead of long-term planning, Congress passed a series of continuing resolutions, kicking the budget can down the road. No material progress was made as the United States approached its self-imposed deadline of August 2, 2011, to raise the budget ceiling. Although the debt ceiling had been raised 74 times since 1952, this was the first time it was to be raised without a formal budget process.

And that budget process clearly has become more of a farce. All the time that might have been used to reach an orderly reduction of spending was squandered in what got labeled by the mainstream media as bipartisan grandstanding. Unable to do its actual job of compromising, Congress delegated its responsibility to a “super-committee” of a dozen senators and congressmen charged with finding more budget cuts or disarming America. This is somewhere between taking yourself hostage and asking for money, on the one hand, and simply telling your mom that you are going to hold your breath until you turn blue on the other. Grownups (i.e., people over the age of five) don't act this way.

Seeing this tantrum, Standard & Poor's and the Secretary of the Treasury, Timothy Geithner, both cited a dysfunctional Congress as an important factor in the decision to

downgrade the U.S. debt because “the effectiveness, stability and predictability of American policy making and political institutions have weakened.”[21](#)

Compounding our domestic problems, the rest of the world has engaged in much of the same profligacy, creating ominous international threats:

- The euro is on the brink of failing as a currency, which will throw international trade into turmoil.
- The developed nations of the world are spending \$4 trillion more than they take in, putting incredible pressure on all Organisation for Economic Co-operation and Development (OECD) currencies as a store of value.
- Our Pax Americana, which has prevailed since World War II, is coming apart at the seams, with our allies increasingly unable or unwilling to support us, and increasingly louder domestic voices in both political parties in favor of isolation, which is called “standing down” when used to describe our military alliances, and “fair trade” when used to describe the desire for more protectionism in our international trade relations.
- We are dismantling our military at the same time our rivals are increasing their commitment to new weapons systems.
- Our traditional allies, the Europeans, have so burdened their people that Europe's population is now shrinking at a faster rate than the Soviet Union's did just before its collapse, bringing into question how long we can rely on any of the Europeans as reliable allies in a world with rising unaligned powers like China, India, and Brazil, and the newly destabilized Arab countries.

So our domestic economy is on the brink, U.S. debt has been downgraded, the dollar is increasingly suspect as a store of value, the worldwide economy is teetering, and the Pax Americana is eroding. Millions and millions of Americans have lost their jobs and much of their life savings. And what

does the public hear about Congress making tough choices? That if we don't increase overall domestic spending by 5 percent from 2010 to 2011, the Cowboy Poetry Festival in Nevada may be in jeopardy.

It is one thing to have a bad Congress when it has little impact on the economy. After the Civil War in the late 1800s, Congress was notoriously corrupt, and the public largely laughed it off. Mark Twain said: "It could probably be proved by facts, statistics and otherwise that there is no distinctly native American criminal class except for Congress." But it is one thing to laugh off Congress when the federal budget accounts for 3 percent of the economy, and quite another when it accounts for 25 percent of our national economy.

The Federal Reserve, acting under its two sometimes conflicting mandates from Congress of price stability and full employment, controls the money supply and sets short-term interest rates. Almost every instance of a troubled industry is troubled because Congress—either directly or through the Federal Reserve or other government entities—has stepped in to change the pricing of that industry:

- In housing, at Congress's insistence, mortgages changed from 20 percent down payments with 30-year fixed rates to as little as 3 percent down with variable rates backed by government guarantees—and people got way over their heads in debt.
- Government stepped into the health care industry and, within one year, the average family's insurance premium increased by 9 percent to \$15,073, 5.8 percent above the nominal increase in CPI of 3.2 percent for 2011.
- In the auto industry, the government mandated fleetwide fuel efficiency standards, and GM and Chrysler became uncompetitive without government support.
- Even in the case of debit cards, the government stepped in and ordered the banks to charge \$0.24 per

transaction instead of \$0.44 per transaction, with the result that the banks have started to raise other fees they charge.

The list of industries where Congress has forced new pricing or terms on previously established, freely negotiated commercial relations is endless. This book will examine several industries in detail, with an eye toward understanding how Congress interfered and made things worse for everyone.

In each case, Congress's new pricing enabled a particular congressman or group of congressmen to get more power or more donations, or both. But most of the time, when Congress changes—or even merely threatens to change—the rules for an industry, stocks of the companies in that industry suffer. This is the Congressional Effect at work.

When Congress sets prices, they are always wrong. When the free market discovers prices, they are at least occasionally right. Without the feedback created by knowing the right price, we will always misallocate capital. The financial benefits to us all of getting Congress to stand down from price fixing are enormous and will be spelled out in detail. What's true for physics is true for Congress. Heisenberg showed us that the measurer affects what is being measured, and this became a key aspect of quantum theory. While we may think we have a Newtonian model of how government works, with simple cause and effect between legislative intent and positive economic effect, every government action in fact has unintended consequences. The mere act of having the government look in your wallet to allocate resources decreases what's in your wallet. But what is predictable is Congress's persistent dysfunction, so investors can learn from this book how to systematically avoid legislative risk in the stock market.

Congress's Role in Wealth Destruction

In William Bernstein's magnificent book *The Birth of Plenty* (McGraw-Hill, 2004), he summarizes what he thinks are the four conditions for a civilization to build true prosperity: property rights, rationality, efficient capital markets, and a good communications and transportation infrastructure. The material progress we have had since the Industrial Revolution has flowed from America's having these four attributes in abundance. But with the accelerating growth of government, particularly during the past 10 years, property rights, rationality, and efficient capital markets have all been sharply eroded in America.

Our progress since the Industrial Revolution has been reflected in our wealth growing at a rate of 2 percent in real returns per capita, per year, since about 1800. That may not sound like a lot, but this seemingly small but relentless improvement was enough to change us from an agrarian society to the modern economy of the twenty-first century. You can think of it this way: Living 2 percent better each year is like getting an extra week of vacation for each year you are working. It is this small but steady rate of improvement that is at the heart of the American Dream: that the next generation will live better than this one.

But lately, government has impoverished all of us compared to what we would have today if it were smaller. For example, deficit spending of nearly 10 percent of our economy on mostly wasteful and inefficient projects is a manifest travesty. What's worse is that the political debate, at least as portrayed by the mainstream media, is typically framed as being about Congress getting the price right, about properly allocating between competing interests, with the government acting as disinterested referee. But the

government is *never* a disinterested referee. Today's government is just as interested in controlling as much property as possible as King George was in 1776. We have arrived at a moment in time where Congress has practically lost its ability to function, to be a serious steward of our nation. Our planning horizon has shrunk from decades to months, and our current solutions are panicky and short term. The increasing rapidity of the news cycle has made political responses all the more volatile and short term. As the media have become more fractured, Congress feels more in jeopardy, and has in turn become more dysfunctional. The ever more granular self-sorting of America into polarized, partisan pockets increasingly threatens politicians across the political spectrum, forcing them to spend political capital to avoid challenges from the more radical elements of their base, whether on the left or the right.

Having said all this, I do not want to leave the reader with impression that all our troubles are always and in every case Congress's fault, especially when it comes to investments. Many forces outside the control of Congress and the United States are rapidly increasing and creating both risks and opportunities. The breakdown of Europe, the rise of the East, and the tech revolution and its implications for productivity and mobility of people and capital are enormous factors for investors that have little to do with Congress but strongly affect your investment returns. But these risks and opportunities are both knowable and much more fairly presented to us by the popular business media every day. In contrast, for over 100 years, the popular press has painted a picture of our government as mostly benevolent when in fact it is mostly the opposite with respect to investments. The goal of this book is to help you recognize, from an investing point of view, why President Reagan's quip that the nine most terrifying words in the

English language are, “I’m from the government and I’m here to help.”

Are there ways to make Congress's relentless dysfunction work for you as an investor? Fortunately, there are. As an investor, you do not have to take it on the chin from Congress all the time. Instead, you can follow Congress's intentions, assess where they will do the most damage, and set up your investments to avoid the risk and damage they inflict.

This book shows you how to use Congress's short-term horizon to enhance your performance relative to the risk you take, and how to use the long term to take your investments safely past each crisis du jour, especially the ones created by Congress for Congress's benefit. You will learn Congress's historically overwhelming and persistent impact on the short-term direction of the market. You will be given investing approaches to make Congress's relentless dysfunction reliably work for you and not against you in figuring out what to do in these manic and unprecedented investment times.

Summary

Ken Fisher once referred to the stock market as “the Great Humiliator.” All honest market participants have been humbled many times by the stock market, and have had their expectations crushed, along with their portfolios. It is the nature of investing that it is difficult to be consistently smarter than the stock market, which represents the second-by-second collective calculation of billions of people with vast distributed and expert knowledge. However, once you understand the nature of the incentives that each politician has that collectively result in Congress's relentlessly working against your portfolio, you will be more easily able to recognize when to use their efforts to your

advantage. After all, in the February 2012 Gallup survey mentioned earlier, Congress ranks dead last in respect among all 16 institutions, including the public schools, banks, big business, organized labor, and health maintenance organizations (HMOs).

If you've ever looked at any of these institutions and thought you could do a better job on something, there is no reason to think that you can't do a better job on your own life savings by avoiding some of the mistakes created by Congress. It turns out that once you see the stock market from their perspective, you will have a better idea of what to expect and how to reduce the casual, relentless damage they inflict on your portfolio every day. As the size of the government has expanded relative to the overall economy, a great deal of damage has been done to the wealth of our nation, particularly over the past decade. While there is always a natural ebb and flow to the business cycle, there is something fundamentally flawed with a political system with so many policies that helped to wipe out a decade of economic progress. Much of this recent and terrible damage is attributable to flawed government policies, many of which come to pass because of the perverse incentives our leaders have to interfere in our lives. In fact, one section this book describes how Congress uses behavioral finance principles to consistently get the *worst* process and corresponding results available when “solving” problems.

We see the impact of these policies in all of our popular measures of well-being—employment and housing statistics, the size of our debt relative to the economy, economic growth and gross domestic product (GDP) statistics, and so on, and almost everyone understands that the economy is in trouble. Not as well understood is the generally negative impact that Congress has on our stock market—both daily and over the long term. This book will help you specifically understand that impact and how to use it to get better

results in your own investing, and give a glimpse of how much wealthier we could all be if we could systematically reduce the negative impact of Congress on our wealth.

Notes

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