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The phrase "unfettered capitalism" seems to be much in vogue these days. The History Channel, not bothering to wait for history to finish recording the matter, has already made a documentary about the causes of our recent economic upset. Many parallels were drawn to the period of the roaring '20s and the Great Depression that followed. Most, if not all of our current troubles, were laid at the feet of "unfettered capitalism" by this documentary. Like many other accounts of the Great Depression, the Hoover administration was seen in this program as not doing enough to alleviate the economic miseries of the day. The lesson of Hoover's subsequent plunge in popularity and eventual defeat for re-election has not been lost on U.S. Presidents since; that is, in the face of economic storm clouds, it is better to do too much than too little. In the current debacle, the Bush and now Obama administrations have taken very aggressive actions to intervene in the economy. If capitalism was unfettered before (we would not have described it that way), it surely isn't now. In the last year we have witnessed government bailouts of banks, brokers, insurance companies, auto manufacturers and their labor unions at great expense to the taxpayers and, even more importantly, to our capitalistic principles. Some of the unforeseen consequences of these actions have already appeared, and no doubt, others will in the future.

Our nation and much of the western world seem to have had their faith in capitalism shaken by recent events. We know of no other system that has benefited individuals and societies more than capitalism. When a friend of ours recently sent us an old interview from the Phil Donahue show, we realized that Milton Friedman could state the case for capitalism much better than we ever could. We encourage you to watch this short segment directly from the electronic version of this commentary by pressing your control button and clicking on the following link:
http://www.nmatv.com/video/1115/Milton-Friedman-and-Phil-Donahue--1979

We believe that there are laws of economics, just as there are laws of physics. Intervene in the natural order of economics, and unintended and unexpected consequences will follow. A great recent example is the government's push to broadly expand home ownership, a very honorable intent. We've seen how that turned out, and now the government is the conservator (a term implying something other than permanency) of Fannie Mae and Freddie Mac with $400 billion now pledged to keep them up and running with no end in sight. Obviously it was not only these government sponsored enterprises that contributed to this disaster, but Fannie and Freddie were the deep pockets (as in big balance sheet, not net worth) providing the moral hazard. If you still haven't read our piece from 2004 entitled "It's Time To Bust Up Fannie and Freddie," please do so by accessing the Commentary section of our website. By doing so, you will recognize that we have never endorsed "unfettered" or unregulated capitalism. In fact, in addition to calling for stricter regulation of Fannie and Freddie, we have also called for regulation of hedge funds and enforcement of naked short-selling rules. Nonetheless, we are realists about regulation. Regulation, by its nature, is always going to be backward looking, playing catch-up and subject to political meddling (see OFHEO, now the FHFA).

Today, Washington is engaged in many debates on plans for further intrusion into the economy. It is fascinating to watch this unfold at a time when we can least afford many of the programs and taxes that are being discussed. The fact that Standard and Poor's recently put the United Kingdom on Credit Watch with a negative outlook does not seem to have sunk in with Washington. The assumption seems to be that we can go on running large deficits with no consequences. Our debt to GDP ratio is very similar to the U.K.'s, causing many prognosticators to predict that it won't be too long before our Treasury bonds no longer carry a AAA rating. This would increase the cost of government borrowing, most of which is now being funded by foreign creditors who are making public their doubts about our credit worthiness and our long-term intentions toward our currency. Washington is in denial as legislation on a tax on carbon dioxide emissions, stricter mileage and emission requirements on autos and plans for further government involvement in health insurance work their way through the halls of Congress.

If the U.S. was as competitive as we used to be, the further costly expansion of government might not be as troubling as it is now. At a time when most of the OECD countries are becoming more fiscally conservative, we are doing the opposite. The U.S. already has the second highest corporate income tax rate of the 30 OECD nations when the income tax of political subdivisions (we refer to them as states) are included. We have seen the movement of many of our corporations to other countries, as our country becomes less business friendly. Just this year, Ingersoll-Rand, Noble Corporation, Weatherford International, Tyco Electronics and Tyco International have exited the U.S. for more business friendly environs.

We recently had a CFO of a Fortune 500 company tell us that his company now views the U.S. as having significant political risk, whereas in the past, that was mostly a concern in doing business abroad. To provide a better sense of how the U.S. stacks up against its competition, we have compiled a list (at right) of industrialized and emerging nations with their credit rating and top corporate income tax rate.

Country	Credit Rating	Tax Rate
Japan	AA	39.5%
United States	**AAA**	**39.3%**
Germany	AAA	38.9%
Canada	AAA	36.1%
France	AAA	34.4%
Brazil	BBB-	34.0%
New Zealand	AAA	33.0%
Italy	A+	33.0%
India	BB	33.0%
Spain	AA+	32.5%
Australia	AAA	30.0%
United Kingdom	AAA	30.0%
South Africa	A+	28.0%
Mexico	BBB+	28.0%
Israel	Not Rated	26.0%
Taiwan	AA-	25.0%
China	A+	25.0%
Czech Republic	A+	24.0%
Russia**	BBB	24.0%
Switzerland	AAA	21.3%
Poland	A-	19.0%
Singapore	AAA	17.0%
Ireland	AA	12.5%

*Tax Rate = Federal plus Average State
**KPMG states that Federal tax authorities determine the applicable rate
Source: IMF, KPMG, Bloomberg

While we are currently at a crossroads, it is important to remember that the public policy process ebbs and flows. We cannot recall a time in our history when one side or the other had it all their way for too long, which has proven to be a very good thing. Going back to '93 as an example, it appeared that many new government spending programs would be enacted when Clinton was elected President. With control of the Congress changing in '94, Clinton began to work with Congress on pro-growth and fiscally conservative initiatives, and the economy and the market enjoyed many prosperous years. At the current stage of the business cycle, it is imperative that we adopt pro-growth policies. There is evidence of a fledgling recovery starting to take place, but anti-growth policies could send the economy back into a free fall. We can no longer afford to enact policies using static analysis that assumes that individuals and businesses will not change their behavior when faced with adverse government initiatives, and that there are no consequences to continually adding to the cost of doing business in this country.

Mid-Year Assessment

The stock market rally that began late in the first quarter continued into the second quarter, with the S&P 500 total return ending in positive territory for the first half of the year at 3.19%. The market seemed to take a breather in June, possibly waiting for further evidence of an economic recovery.

In the bond market, Treasury bonds were pounded in the first half of the year, as the anticipation of a flood of new bond issuance by the Treasury weighed on the market. The 30 year, 10 year and 5 year Treasury bonds returned -24.33%, -9.06% and -2.74% respectively for the first half of the year. Corporate bonds enjoyed good returns, as investors took advantage of very wide yield spreads to Treasury bonds and anticipated a recovery in the economy.