Crony Capitalism and Big Business Wins

No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future.
– Ian E. Wilson (former Chairman of GE)

"Good news, Connors. I'm elevating you to crony."

CartoonStock.com

Dealing with uncertainty is challenging for most people, yet it is an inevitable fact of life. Many of us are okay accepting a certain amount of uncertainty throughout our lives as long as the risk (downside), the reward (upside), and the duration (time this all takes to play out) are well defined. With regards to this Virus, the downside (death) and the upside (a therapeutic or vaccine) are well defined, yet we are completely in the dark when it comes to a time horizon associated with managing the above. This open-ended aspect of the global pandemic is difficult for many of us to chew on, as I don't believe we humans are well suited to process this in a rational manner.

Uncertainty and investing go hand in hand. However, the worst thing that can happen to an investor is that he/she goes broke. This is a risk some people are willing to take when balanced with the potential upside. In today's investing landscape, many people are just trying to hang on to what they have and minimize unnecessary risks. This of course is understandable.

Today, the investments which seem to be winning or rebounding the most are those that have the attributes of a sure thing. And by a sure thing (there are no actual sure things when it comes to investing), I mean the large, well-known companies, industries and asset classes that are friendly to and supported by our government.

Ed Yardeni, of Yardeni Research is one of the very few popular economists and investment strategists I listen to. I felt the below article published on his blog on Crony Capitalism was thought provoking and would be of interest to many of my readers. See below.
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Fed Eats Buffett's Lunch
By Ed Yardeni

In my recent conference calls with our accounts, I've been making the case for investing in crony capitalism. This system differs from entrepreneurial capitalism where the business of companies is to compete with one another fairly and squarely for their customers' business. Entrepreneurial capitalists who fail to do so go out of business. Those who succeed prosper.

The problem is that successful entrepreneurial capitalists tend to become crony capitalists when they pay off politicians to impose legal and regulatory barriers to market entry by new competitors. It doesn't seem to matter to them that they succeeded because no such barriers blocked their access. Rather than cherish and protect the system that allowed them to succeed, they cherish and protect the businesses they have built.

A related problem is that politicians view successful entrepreneurial capitalists and their companies as ideal candidates for so-called "rent extraction," otherwise known as "extortion." Politicians threaten to use their powers to regulate business to the disadvantage of companies that don't cooperate with their agenda, which is mostly about getting reelected and more power. Crony capitalism is the result of Big Business colluding with Big Government for their mutual benefit.

President Calvin Coolidge, in a January 1925 speech to newspaper editors, famously said, "The business of America is business!" That's no longer true for many big enterprises. Doing business with the government has become increasingly essential for companies, as the government has become a bigger customer for many of them and also more powerful in regulating all of their businesses. Despite recurring promises by presidential candidates to banish "special interests" from running Washington, the lobbying industry continues to flourish and grow in our nation's capital, reflecting the symbiotic growth of Big Business and Big Government, i.e., the triumph of crony capitalism. The lobbying industry is their love child.

President Ronald Reagan famously said, “The nine most terrifying words in the English language are “I'm from the government, and I'm here to help.” On November 18, 2008, Rahm Emanuel, the chief of staff for President-elect Barack Obama, famously stated, “You never want a serious crisis to go to waste. ... This crisis provides the opportunity for us to do things that you could not before.” Lots of politicians and policymakers follow “Rahm’s Rule for Politicians,” as I call it. If Rahm’s advice seems Machiavellian, well, it is. Sixteenth-century Italian political theorist Niccolò Machiavelli advised in his famous treatise The Prince: “Never waste the opportunity offered by a good crisis.” However, it was Winston Churchill who reputedly popularized the sentiment.

Which brings us to the Great Virus Crisis (GVC). The government is here to help, and to get bigger trying. The CARES Act signed by President Donald Trump on March 27 gave the US Treasury Secretary Steve Mnuchin the power to provide up to $2 trillion in assistance to rescue the economy.

The Act provided for $32 billion in grants for the airline industry for payroll support and $25 billion in direct loans or loan guarantees from the Treasury to support passenger air carriers. The CARES Act “requires the Secretary to receive warrants, equity interest, or senior debt instruments issued by the loan recipients as compensation for providing the loans,” according to the Congressional Budget Office.

Businesses that need bailouts, such as the airline industry, will be beholden to the whims of politicians to manage their affairs. That’s why I advocate investing in companies that are likely to benefit from the triumph of crony capitalism. They are big businesses with strong balance sheets that are positioned to survive and even to prosper during the post-GVC era ahead. They don’t need rescuing by the government.

Warren Buffett seems to agree, at least about the prospects for the airline industry. He is widely revered as one of America’s great capitalists. While there is some debate on where he is on the spectrum between entrepreneurial and crony capitalism, his annual meeting of Berkshire Hathaway shareholders is dubbed “Woodstock for Capitalists.” Consider the following:

(1) Dumping airlines. On Saturday, at Berkshire Hathaway’s first virtual annual meeting, Buffett revealed that he sold his sizeable stakes in all his airline stocks. He said: “The world has changed for the airlines. And I don’t know how it’s changed, and I hope it corrects itself in a reasonably prompt way. … I don’t know if Americans have now changed their habits or will change their habits because of the extended period.” But, he added, “I think there are certain industries--and unfortunately, I think that the airline industry [is one], among others--that are really hurt by a forced shutdown by events that

are far beyond our control."

(2) Praising the Fed. Buffett was impressed by the Fed's QE4ever announcement on March 23. In addition to unlimited and open-ended QE purchases, the Fed moved for the first time into corporate bonds, purchasing the investment-grade securities in primary and secondary markets and through exchange-traded funds. On April 9, the Fed provided term sheets explaining that Special Purpose Vehicles (SPVs) to do so would be funded by capital provided by the Treasury through the CARES Act.

Buffett said, "They reacted in a huge way." The bond market "had essentially frozen" just prior to the Fed's action. Yet April turned out to be "the largest month for corporate debt issuance … in history," he said. He added, "Every one of those people that issued bonds in late March and April ought to send a thank you letter to the Fed because it wouldn't have happened if they hadn't operated with really unprecedented speed and determination." On Thursday, April 30, Boeing was able to raise a stunning $25 billion in funding, allowing it to avoid government help even after it said last month that it would seek $60 billion in federal bailout money.

(3) Getting outbid by the Fed. Buffett isn't a sore loser. But he should be, given that the Fed acted before he had time to do what he does best—i.e., to take advantage of a financial crisis to buy cheap assets with the record $137 billion on Berkshire Hathaway's balance sheet. He hasn't made a major acquisition in several years, not having found anything "that attractive."

Actually, there were lots of attractive distressed assets resulting from the 33-day bear market in stocks from February 19 through March 23. But Buffett couldn't act fast enough since the Fed and the Treasury came to the rescue so quickly with so much cash. They are here from the government, and here to help.

(4) Fort Knox. Then again, Buffett seems to be spooked by the GVC, and is worrying about a second wave of infection. Rather than using his cash for acquisitions, he prefers to use it to fortify his company against "worst-case possibilities." He said, "Our position will be to stay a Fort Knox."

An October 16, 2008 NYT op-ed by Buffett was titled "Buy American. I Am." Now, as then, Buffett believes in America. At the recent meeting he said, "The American miracle, the American magic has always prevailed, and it will do so again."

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Given the large rebound in markets from the March lows, I am becoming a bit more cautious in the very near term. Nevertheless, I remain optimistic due to both the large monetary and fiscal response from our government as well as governments globally, and believe equity markets broadly will be higher, while long term US bond yields will be lower by years end. Some people are calling it a “melt up” and that sounds about right to me.

Lately, I have been reading and hearing analysts harp over economic statistics and corporate profit expectations. To this I say, “They are meaningless in our current environment.” Investors should be looking beyond the recent shock, and therefore using comparison statistics broadly affected by a self-inflicted outlier event (we decided to turn off the economy in response to the virus) seems inappropriate. But you don’t need to take it from me. The Market Ear, which is an excellent blog for sophisticated market operators recently summarized David Zervos, who is the well-respected chief market strategist at Jefferies. “Since there is a robust Fed liquidity backstop, and we don’t know the depth or duration of the current economic downturn, spending any time looking at economic data releases or focusing on corporate earnings is a colossal waste of time. He points out that for economic data, the signal to noise ratio is essentially zero, and for corporate earnings, near term results are meaningless with regards to long term earnings potential. He believes that focus should instead center on the Fed, and sees their direct support for the financial and nonfinancial Investment Grade corporate sectors in the US as the single most important driving force for capital markets…” I agree.

ASSET CLASS & SECTOR OPINIONS		
OVERWEIGHT	**NEUTRAL**	**UNDERWEIGHT**
U.S. Real Estate Equities	**Materials Sector**	**International Developed Market Equities**
Large Capitalization Technology	**Communication Services Sector**	**Financial Services Sector**
Consumer Discretionary Sector	**Healthcare Biotech & Pharmaceuticals**	**Leverage Loans (Floating Rate Debt)**
Healthcare Equipment	**Consumer Staples**	**Treasury Inflation Protection Securities**
Aerospace & Defense	**Mortgage Backed Securities**	**Energy Related Equities**
Investment Grade Corporate Bonds	**Local Currency EMG Bonds**	
U.S. Treasury Notes & Bonds	**High Yield Corporate Bonds**	
Gold	**Emerging Markets Equities**	

Sincerely,
Justin Kobe, CFA
Founder, Portfolio Manager & Adviser
Pacificus Capital Management

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