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Beyond Broken Windows: What if the Market is Right?

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When the markets closed on September 10, the last day before the terrorist attacks on New York City and Washington DC, the S&P 500 was at 1092.54. This last Friday it closed at 1104.61 -- *1.1% higher*. The NASDAQ closed at 1695.38 on September 10. Last Friday it closed at 1768.96 -- *4.3% higher*.

How is it possible, considering that the economy was skidding into recession even before the terrorist attacks? *How is it possible*, now that the global economy has been saddled with the additional costs and risks of an open-ended "war on terrorism" and a new obsession with safety and security? *How is it possible*, after a catastrophic earnings season in which the S&P 500 has reported earnings down anywhere from 20 to 25% year-on-year -- the steepest such decline in the index's long history, according to our friends at **Morgan Stanley**?

It could be that the market is simply *wrong.* It could be that a volatile combination of relief, patriotism and wishful thinking is at work. And it could be that there is a vast coordinated propaganda effort in play to promote just such thinking. We know that the **Securities and Exchange Commission** relaxed their rules to encourage share repurchases. Is it so far-fetched to imagine some private high-level phone calls offering similar leniency in reporting, in order help CEOs make their quarters ("Uncle Sam Wants You -- To Make Your Quarter!" October 19, 2001)? And is their any other explanation for the media's inexplicable silence about what must surely be the most horrendous quarter in history for 401(k) plan participant accounts?

If this is the case (and I fear that it might well be), then it's just a short matter of time until reality catches up with us and we end up re-testing the lows of September 21.

But on the other hand, it could be that the market is *right*. After all, it usually is. So let's explore how this might be so.

As we discussed last week ("43,600 Broken Windows," October 24, 2001), more than a century and a half ago the French economist **Frédéric Bastiat** demolished the fallacy that destruction of property and its subsequent repair could stimulate economic activity. His classic example of a village baker's broken window showed that the demand generated by the need to repair was nothing more than the diversion of demand that the baker would have otherwise directed somewhere else -- and, of course, the asset account on the baker's balance sheet has been reduced by the value of one window.

So what is there about the prospect of repairing 43,600 broken windows -- the number of windows in the two World Trade Center towers -- that the market seem seems to like so much?

Well, first let's recognize that the economic activity set in motion by the September 11 terrorist attacks is far greater in scope than simply the repair of damaged property. For the post-attack world, it is a global campaign to repair a damaged sense of safety and security that will be carried out first by military and police action, and then for many years in the future through all manner of defense and security activities. In Bastiat's terms, it is as though the breaking of the baker's window set in motion a massive campaign against crime and for the protection of assets throughout the baker's village.

The pessimists will argue that the costs of this campaign are like a tax. They divert resources to meet explicit costs such as military technology, the expenses of armies, insurance, and security apparatus; and opportunity costs such as constrained travel, diminished liberties, and extra time spent waiting in line for security checks. Government estimates of these costs have mounted to the trillions.

The diversion of these resources is a bad thing if they would have otherwise been committed to higher and better uses. But what if it is the case that they would otherwise, without the terrorist attacks, have gone to *lower* and *worse* uses -- or to what if they would have gone to *no use at all?*

We have to consider the possibility that defense and security costs *are* the highest and best uses of the economy's resources.

Is it possible that, by failing to bear the costs of abating global terrorism or of protecting ourselves from it, we have been penny wise and pound foolish? Yes, we have saved those costs for as many years as we have failed to pay them -- that is money in the bank, and would seem to be a good thing. Superficially, it has been like driving a car without liability insurance, or owning a home without fire insurance. It's not a problem unless there's a problem. And for many years there wasn't a problem.

But in an efficient underwriting market, the cost of insurance is logically indexed to the probability and value of casualties, so insuring does little more than smooth out the outcomes over time. But the war on terrorism and the increased emphasis on security are not simply savings schemes for optimizing the costs of statistically inevitable casualties. They are about preventing casualty losses in the first place -- losses which, when they occur, entail incalculable cost in objective and subjective terms. Rather than thinking of these costs as buying insurance for an uninsured car, think of them as installing brakes on a car that had not previously been equipped with them. Those brakes have a cost, but they complete the system and make it infinitely more useful: as a website visitor reminded me, **Joseph Schumpeter** once remarked that brakes allow cars to go faster.

Some evidence that the market sees things this way can be inferred from the fact that last week, as the broad markets surged back to pre-attack levels, the theme-stocks representing military defense, homeland security, and bioterror countermeasures surged even more ("Theme Song: It Jihad To Be You," October 18, 2001). If defense and security costs were deadweight losses, you would expect to see a zero-sum game in which broad market gains came only at the expense of losses in defense stocks, or vice versa. But, instead, what we saw was a positive-sum game in which *both* were higher at the same time.

It is also possible that -- even if defense and security costs are not the highest and best use of resources -- the market is celebrating the fact that at least those resources are getting deployed at all.

Before the September 11 attacks, the monetary and fiscal policy environments were dominated by lockbox lunacy. Nothing could get done in Washington that didn't at least appear to balance the budget, grow the surplus, pay down the debt, or save Social Security as we know it. Now, though **Alan Greenspan's** idea of "easing" is a timid interest rate policy that has the price of gold unchanged from pre-attack levels ("Gold: Back to Square One," by David Gitlitz, October 22, 2001), and though **Congress's** idea of "stimulus" is an idiot's delight of populist pabulum ("A Bipartisan Bungle," by David Gitlitz, October 25, 2001) -- at least it's something. In Bastiat's terms, it is as though the economic activity inspired by the need to repair the broken window came at a time when the baker would have otherwise just have hidden all his money in his pillowcase and done nothing at all with it. Even repairing a window would look good in terms of the measured economy.

Beyond these purely quantitative dimensions, we cannot rule out the possibility of qualitative forces at work, too. For me and my colleague **David Gitlitz**, it is axiomatic that markets are moved by changes in the conditions that favor wealth creation by economic producers. Typically those changes occur in economic incentive structures -- but there are other types of changes that lead to wealth creation, as well, and perhaps we are seeing an example of one of them. And maybe *that's* what is moving the market.

As I pointed out the day after the attacks ("In Crisis, Opportunity," September 12, 2001), "…crisis mobilizes the commitment of human energy -- from what economist **John Maynard Keynes** called our 'animal spirits.' In the 1930s he recognized that the world's great depression was, as much as anything else, a collapse of animal spirits, the failure of a discouraged people to take risks and commit their energies. Today in our post-boom recession we find ourselves in much the same psychological state of hopelessness and fear."

Perhaps no longer. As an insightful institutional client wrote on *TrendMacro Live!*, "…It has to do with many things but coherence is a prime one. Consider photons, coming off your ordinary light bulb; they provide light to work and live by, but make those photons coherent and they perform miracles as lasers in eye surgery and pinpoint targeted bombs… Has the US ever been as coherent as it is today? Not in my lifetime."

And it's not just the US. The war on terrorism has aligned the incentives of all industrialized countries to a new level of coherency. For every grain of sand in the gears of commerce imposed by having to pay for extra levels of security at each stage of global trade, buckets of sand are being cleared away in an effort to knit together a security alliance. At this point are we going to let little things like nuclear proliferation and human rights hold up the sale of hundreds of millions of dollars worth of jet fighters to Pakistan?

No way. We're running a Jihad for capitalism now. And maybe the market is telling us that it's working.