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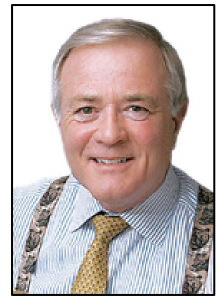

William Rutherford

A third depression?

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In a recent article in The New York Times, Nobel laureate Paul Krugman raised the specter of a third depression for the United States. A Nobel Memorial Prize in Economic Sciences is a strong credential, and Krugman makes a strong case.

Krugman's thesis is that the U.S. and Europe are now doing what the American government notoriously did to create and prolong the Great Depression. He also refers to the years of deflation and instability that followed the panic of 1873 as the "Long Depression." In both cases the government followed a policy of austerity and balanced budgets, which Krugman says exacerbated the financial woes. Krugman believes we are either in a depression comparable to the 19th century model or about to be in one comparable to the 20th century model.

Joining the debate is Robert Prechter, an advocate of the Elliott Wave theory who forecasts a long slide bigger than either of the earlier depressions. He believes the Dow will fall to well below 1,000, in a crash larger than the South Sea Bubble of 1720.

It is tough to argue with them. First, my credentials don't begin to match either of theirs. My education was in history and economics, and the law. I have been a businessman most of my life, but also a lawyer and a public servant elected to statewide office. I have not won any prizes for any of these - well, Rutherford Investment Management has received a five-star rating from Morningstar, but nothing rivaling a Nobel Prize. They also have a lot of factual support for their point of view. My college economics professor would have agreed with them.

In support of the Krugman thesis, housing prices have plunged in the U.S., and the stock market has suffered its worst decline since the Great Depression. Trillions of dollars in household wealth have vanished.

Worse yet, the trend continues. The latest pending home sales figures show a 30 percent decline for May, nearly triple the drop that had been expected.

The job market has remained persistently weak. The official unemployment rate has barely declined to 9.5 percent only because so many people have given up and dropped out of the workforce. The real rate of unemployment is much higher.

Manufacturing data has disappointed. Furthermore, hourly wages, and the prices of oil and gold have all declined. These indicate deflation.

All of these factors led the market to slide 10 percent in this past, volatile quarter. Additional worries were sovereign debt problems and the "flash crash of 2:45 p.m." Many began to ask if the U.S. is on the verge of a double-dip recession. Krugman posits much worse.

Will we have the double dip? Will we have a depression? Are Krugman and Prechter wrong?

They are wrong, John Paulson said recently in a speech at the London School of Economics and Political Science. Paulson is not an economist, but rather a hedge fund manager. He earned wide fame in the recent market crash, earning billions of dollars for his investors. "We're in the middle of a sustained recovery in the U.S.," Paulson said. He also said that "the risk of a double dip is less than 10 percent," "it's the best time to buy a house in America," and "California has been a leading indicator of the housing market and it turned positive seven months ago." Is Krugman an ivory tower professor? Is Paulson just a lucky gambler? Krugman has his reputation on the line; Paulson has real skin in the game.

It really boils down to policy. Is this government's policy to grow government and spend more billions of dollars that we do not have, or, as Republicans argue, is it time to go on a diet and become austere? One thing is clear: Until the government realizes that its number one priority is job creation, we will not have a meaningful recovery, and we may fall into a double dip. Personally, I subscribe to the slow recovery scenario as adopted by the Fed, and yes, there may be a 20 percent possibility of a double dip, along with a slim possibility of a depression. I am closer to the Elie Ayache school of thought. The real problem now is deflation, and the problem of the future is how to pay for our debt. The global economy is slowing, but still has strength underlying it, and yet it continues to face large problems in housing, employment and credit.

We need a government with a laser-like focus on job creation, but we are not getting it today and we are not going to get it. President Obama has led the Democrats on one wild hunt after the other, missing opportunities to aid the economy, while the Republicans seem to have no plan at all. In November we are going to get a massive disruption of the status quo. The president will lose a lot of his clout in Congress, and may even become a lame duck. Of course, he can always count on the Republicans to snatch defeat from the jaws of victory.

My verdict? A recovery. Just.

What should an investor do? Ayache, in his new 500-page book "The Blank Swan," says "real" prices for securities are unknowable because the numbers are all derived from an unpredictable future, based on elaborate hypothetical reality where probabilities are assigned to a wide range of potential outcomes. Prices, therefore, are quite unknowable, and change along with investors' moods and the supply of money.

Keep money invested. Dividend yields on stocks now exceed the yield on 10-year Treasuries, meaning that if stocks go nowhere for the next 10 years, at current yields, and with no improvement in earnings, stocks will outperform bonds, if they maintain their dividends. It now appears that bonds are riskier than stocks, and more likely to produce losses. A prudent bond portfolio would be ultra short, about two years duration, but yielding only 0.6 percent. With inflation running at more than 2 percent, money will be lost - guaranteed. Of course there is always cash, which while currently earning little, would do well in a deflationary economy. Stay diversified.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a five-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" For investment information contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com