

## THE STATE OF AMERICAN CAPITALISM

*Capitalism: an economic system characterized by private or corporate ownership of capital goods, by investments that are determined by private decision, and by prices, production, and the distribution of goods that are determined mainly by competition in a free market.*

- Merriam-Webster Dictionary

American Capitalism began in the early 1900's and has taken its place as the paragon of global modern capitalism through constant evolution and adaptability. With the recent troubles in the credit and stock markets, the U.S. government has been forced to take action that has led many to contemplate the current state of American Capitalism. Although increased government involvement may seem anti-capitalist in nature, when examined within a historical context it represents a continuing evolution in America's capitalist history rather than a deviation from capitalism.

### **Government Bailout of Publicly Traded Companies**

The U.S. government made multiple controversial steps during 2008 in an effort to stabilize the financial system. In March, the Federal Government took the first of many seemingly anti-capitalist steps in aiding publicly traded companies. Bear Stearns was on the verge of collapse from its exposure to the sub-prime mortgage crisis when the Federal Reserve stepped in to arrange and partially finance a deal for J.P. Morgan Chase to buy the company. In September, the Fed established an 80% stake in AIG with a loan of \$85 billion to help prop up the ailing insurance giant. In between these two occurrences, Lehman Brothers was allowed to fail and Fannie Mae and Freddie Mac, two government sponsored enterprises implicitly backed by the U.S. Government, were *explicitly* taken over by the government. As all of this was happening, storied firms like Goldman Sachs and Morgan Stanley were forced to redefine themselves in an effort to escape the same peril that vaporized competitors Bear Stearns and Lehman Brothers. This government intervention all but wiped out the shareholders of AIG, Fannie Mae and Freddie Mac. The very nature of our capitalist society seemed threatened by government bailouts of entities that had not managed their own risk appropriately.

### **Ban on Short Selling**

The U.S. government also interfered with the markets by banning short sales of financial stocks in September. A short sale is when an investor borrows a stock and then sells it hoping to buy it back at a lower price later. This is a popular strategy for investors expecting stocks to decline in value. This temporary ban eventually ballooned to encompass almost 1,000 companies, many of which were not primarily financial institutions at all. Suddenly, the rules had changed for many investors, including hedge funds that often short stocks as part of their investment strategies. With this restriction, U.S. markets had shockingly become less free than many foreign markets.

### **Government Injection of Capital into Banks**

After bailing out entities like Bear Stearns and AIG, and temporarily banning short selling, the markets awaited the next major intervention. It manifested itself in a redefined bailout plan with the U.S. government taking equity stakes in U.S. banks – thereby directly injecting them with capital and shoring up their balance sheets to help defrost the credit markets.

With the bailout of publicly traded companies (which now includes the U.S. auto industry), the potential for the government to suddenly change the rules, and the direct injection of capital into our banks, it is easy to paint an ugly, desperate portrait of the current state of American Capitalism. In fact, many believe capitalism has failed us. While some will inevitably associate these actions with the unseating of America as the primary global leader, they can also be viewed as part of the ongoing cycle that defines American Capitalism. Throughout this country's history there have been economic conditions that encourage laissez-faire approaches as well as circumstances that demand direct government intervention. This can be seen in hindsight as economic crises are often preceded by seemingly lax regulatory environments and followed by much more stringent regulatory times.

### **The Role of Regulation in the Evolution of American Capitalism**

While a capitalist society is defined by free markets, it still needs some degree of oversight to keep the system working efficiently. The degree of oversight has varied throughout history. Capitalism by its very nature creates cycles of regulation and deregulation. Regulation loosens when economies grow and tightens after a crisis. For example, after the Panic of 1907, a crisis also concerning the U.S. banking system, the Federal Reserve was created in 1913 to act as this country's central bank. Likewise, the years following the Great Depression spawned the reorganization of the Federal Reserve (since it failed in its role during the Depression) and the creation of the Securities and Exchange Committee (SEC). Nearly three quarters of a century later, the enthusiasm of the technology and large cap bubble created the "irrational exuberance" that led to the accounting scandals surrounding Enron, Tyco and WorldCom, to name a few. As a result, Sarbanes-Oxley, a regulation that requires CEOs and CFOs to approve company financial statements personally, was introduced. Of course much has happened in between these examples, but nearly every boom in history has resulted in a bust that created new regulations. Likewise the years leading up to the current situation will be remembered as a period of deregulation, while the years ahead will be defined by regulation.

### **The System is Working**

Even during this inflection period that has stoked fears of socialism and moral hazard, it is important to point out that the system is working. The most comforting example is the sale of Wachovia to Wells Fargo. In late September, Wachovia was involved in a government-brokered deal where it was to be sold to Citigroup to avoid having the Charlotte-based bank fail. In early October, Wells Fargo upended that deal when it agreed to buy Wachovia *without* government assistance. Even when a government bailout seemed the only choice, the private sector found a way to get it done. American Capitalism is still alive! In the face of imminent disaster, the market continued to function which is nothing short of remarkable. We would expect more examples to

surface over the next few months, but at the very least this instance gives us confidence that the system is working even without government intrusion.

### **What is the Current State of American Capitalism?**

The current economic environment has been a direct product of low interest rates, easy credit and the use of leverage and debt by financial institutions, corporations, investment banks and ordinary citizens. These factors helped produce a hyper real estate market which eventually created the toxic securities that have led to the government's recent intervention. While this recent government intervention has been ugly at times, it has also been necessary. Without it the credit markets would have likely frozen solid and many of the economies of the world would have come to a screeching halt. The response has seemed unorthodox at times, but it will likely prove to be just another example of the adaptability and resolve that has come to define American Capitalism over the years.

In summary, American Capitalism has been shaken, but is not broken. The very nature of capitalism helps create these cycles and we must navigate them as best we can. The system is working and we will likely emerge from this experience a nation and a world less dependent on debt and leverage with better incentives to live within our personal and corporate financial means. While this de-leveraging process is painful, it is a necessary step to reestablish equilibrium in the world's capital markets.

### **Looking Forward**

We are confident the system will continue to work and the current tempest will pass. We anticipate stock prices will be significantly higher over the course of the next few years. After the last nine bear markets, the Dow has rebounded an average of 31.7% over the following twelve months. In light of this, we are reviewing each of our positions to verify they have the wherewithal to turn the corner as the markets recover. Additionally, we continue to look for and purchase new positions with the potential to appreciate 50% to 100% over the next 2-4 years. Now is the time to build the foundation for future success.

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