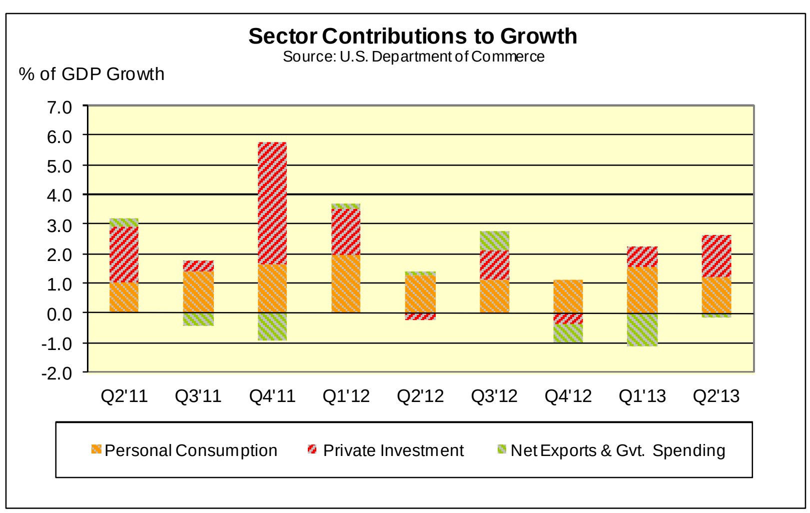
During the Normandy invasion in World War II there were a number of French villages caught in the crossfire between the Allied armies coming in and the German army being stubborn about leaving. Two of the biggest American strengths during that war were (still are, actually) air power and artillery, both of which were used liberally to evict said pesky Germans. Sadly, this didn't leave the French villages quite as picturesque after being freed as before, and one of the running bits of dark humor among the GIs entering these flattened burgs was (we're paraphrasing here) " we liberated the heck out of this town."

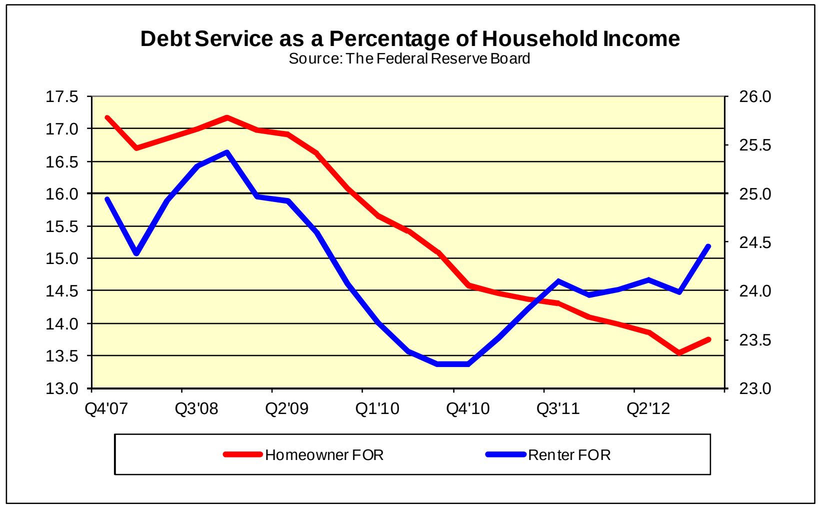
These thoughts come to mind while observing the latest installment of "let's liberate the heck out of this economy" policymaking in Washington. We have sympathy for both sides of the grand argument: its undoubtedly true that we can no longer afford our bloated, inefficient government and that we have to make some hard choices about the long-term viability of our social safety net. It's also true, however, that some modest increases in tax revenues are needed to ensure that we don't trash the good parts of our current safety net, that we improve access to health care for people of modest means and that we continue to make necessary investments in education and infrastructure. It shouldn't be that hard to find common ground. Unfortunately both armies, in their zeal to save us from the wicked and misguided partisans on the other side, would rather risk burning down the village than to give an inch.

Fortunately, some measure of common sense once again prevailed and another dramatic (if you haven't seen the movie before) last second deal (that they could have had months ago) re-opened the government, saved the republic from default and rolled the whole thing forward so that we can enjoy another festive fiscal food fight over the holidays. The erstwhile combatants have promised that they will use this latest cease fire to hammer out a long-term budget deal, but don't hold your breath. Here in Texas, meanwhile, we are left to ponder the question of why our quarterbacks (Matt Schaub) and senators (Ted Cruz) seem to have developed a proclivity for throwing touchdowns to the wrong team. The Administration, meanwhile, won't have much time to savor their victory over the defund Obamacare crowd before someone notices that the roll out of the healthcare exchanges (three years in the making) has been an unmitigated disaster. They should have latched onto the proposal to delay implementation for a year while they had the chance.

The real pity of all this is that the nation's economy continues to be held hostage by the lack of comity on the Potomac. High levels of uncertainty over regulation and taxes continue sapping the animal spirits necessary for the economy to snap out of its torpor. As Julie Andrews' character puts it in *The Sound of Music* (we're nothing if not eclectic in our cultural references): "this night air is not good for the children's voices."

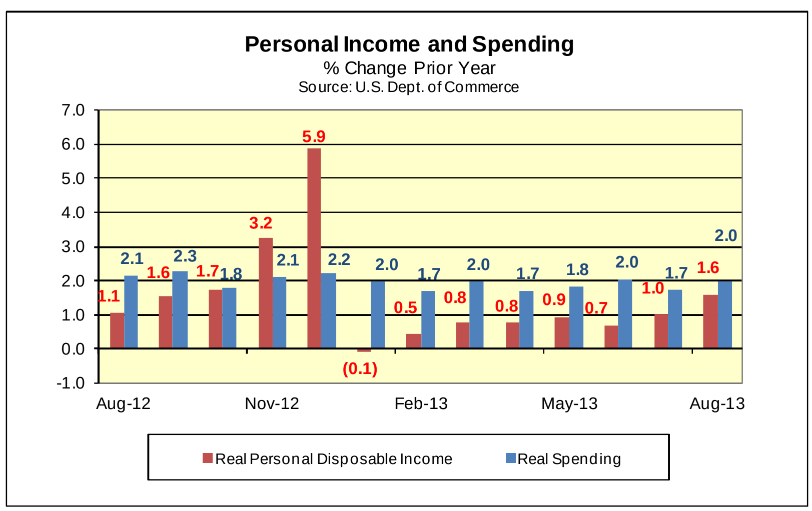


Considering all the night air that's been wafting around, the economy has actually been doing reasonably well. Not fabulous, but okay given the circumstances. GDP growth during Q2, for example, clocked in at a surprisingly stout 2.5%. It's more than a little sad that we've taken to describing 2.5% growth as "surprisingly stout", but we were expecting something closer to 1%, so we'll take it.

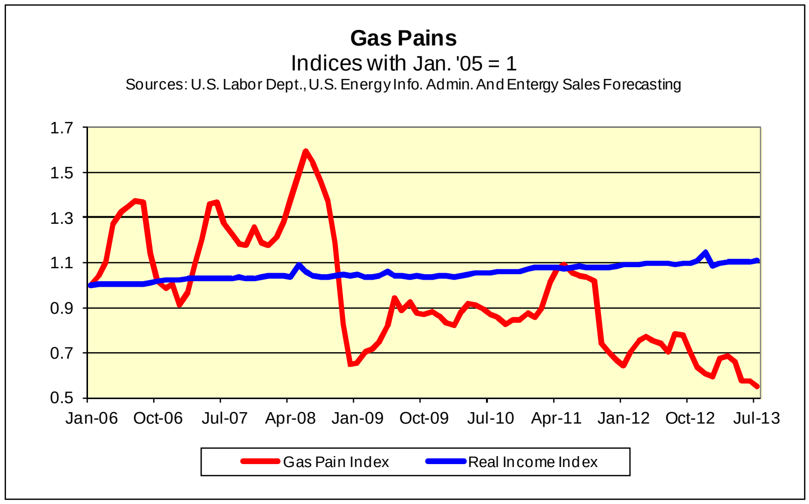


Consumers fought off the negative drag created by tax increases and higher gasoline prices (early in the year) to keep spending. They've had to borrow some to do it, but not so much as to be a worry. Business investment picked up from the lackluster pace of Q1, although some of that was in the form of inventory accumulation that we're not sure really happened (recent inventory reports have been distinctly uninspiring. One of the nice things about the government shutdown has been that the government has ceased issuing economic reports that don't make sense. We haven't been getting any fresh data, but we also haven't had to analyze any goofy government reports that make our head want to explode. Small blessings.) State and local governments are feeling a little more flush these days, and their increased spending mostly offset Federal cutbacks resulting from the sequester. Even net exports stopped being a serious negative as the European economy actually started to grow again and the Chinese economy put on another growth spurt.

The initial read on Q3 GDP, whenever that occurs, will likely show growth in that 2% to 2.5% range, maybe a little better depending on whether the Europeans and Chinese were able to sustain friskiness. The Q4 outlook is a little cloudier, depending on both the direct and indirect impacts of the government shutdown. Economists believe the direct impact will be to shave GDP growth by 0.3% to 0.5%.

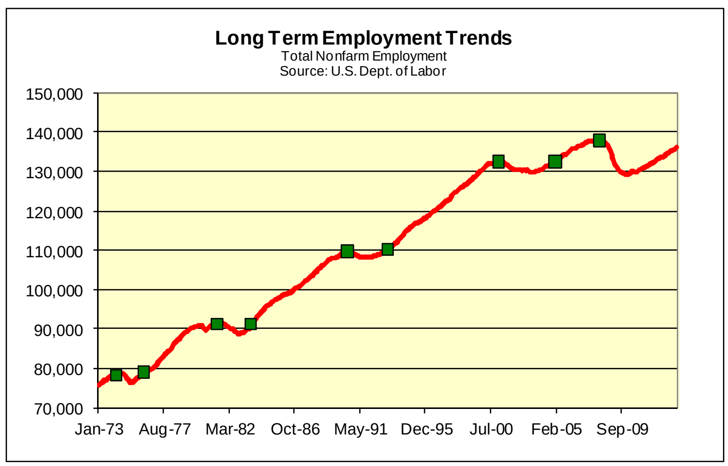


The more important factor will be the indirect impact on consumer and business confidence, especially with the holiday shopping season looming. There are a couple of potential positive offsets, however, which make us more optimistic than you'd probably expect. One is that the negative impacts arising from the budget sequester tax deal last year are starting to fade. When combined with an okay jobs market that's providing a lift to real personal disposable (after tax) income. This could change pending the outcome of the economic liberation discussions in D.C., but we'll cross that bridge when we come to it. Second, a combination of less driving, more fuel efficient autos and lower gasoline prices (after the brief spike early in the year) is freeing up disposable income previously spent on fuel for other forms of consumer spending. Our back of the envelope calculation is that roughly $50 billion in spendable income has been added over the past year from this source alone.



Prior to the government budget kerfuffle the big policymaking news was the Federal Reserve's decision to not "taper" in September. You'll recall that the Fed floated a trial balloon this summer that they would consider cutting back on their $85 billion monthly bond purchase program known as QE3 if the economy, and more specifically the jobs market, showed signs of progress over the summer. Financial markets, after a brief period of consternation adjusted to expectations that the Fed would start the taper in September, so imagine their surprise when it didn't.

Two factors led to this decision. First, the Fed was worried that the budget negotiations would dissolve into a bloody fiasco and that it wouldn't be quite the thing to do to tighten (even if ever so slightly) in the midst of all that. Good call there. But the second reason is that for all the wishing and hoping the labor market recovery remains distressingly mediocre. One of the on-going sources of bafflement since the end of the recession has been the inability of the economy to snap out of its job growth funk. From the peak of employment in January 2008 to the low point in February 2010 non-farm employment declined by 8.7 million positions. Since then we've regained roughly 6.7 million of those jobs, but that still leaves us two million shy of peak. Given recent trends we won't top the previous peak until late next year, or more than six years after the unpleasantness began.



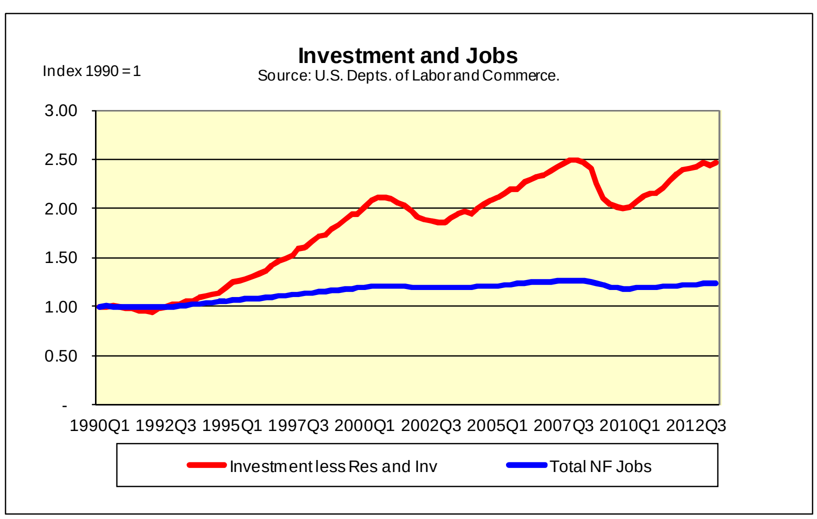
Recession	Months to Regain Peak
1973	20
1981	29
1990	33
2001	49
2007	67+

It's not just you, that's a really long time. Compared to the previous four recessions since the 1970s (the 1980 and 1981 recessions are grouped together since 1980 was so shallow and quick) that beats the previous record slow recovery (2001) by over two years. To provide some perspective, six years ago people under the age of 65 actually went to a certain mall-based retailer (that, to avoid offense, we'll refer to as K.D. Nickel) for reasons other than to use the restroom or because it was the only place at the mall to find a parking space. Government workers at that time hand delivered things called letters directly to your house. If you wanted the latest news, trees had to die. Yes, that long.

Numerically inclined readers will also note a certain pattern: the recoveries keep getting longer. It took less than two years after the 1973 recession for jobs to hit a new peak, or roughly the amount of time it took for things to start falling off a new American car of that vintage. Not to digress, but our first car was a mid-70s vintage Ford Pinto that, shortly after the new car smell faded periodically refused to go into reverse. Putting the transmission into "R" was more of a request than a command. Fortunately, nobody ever rear-ended us or we probably wouldn't be having this conversation now, as Pintos also had the unfortunate tendency to turn into giant Zippo lighters after collisions.

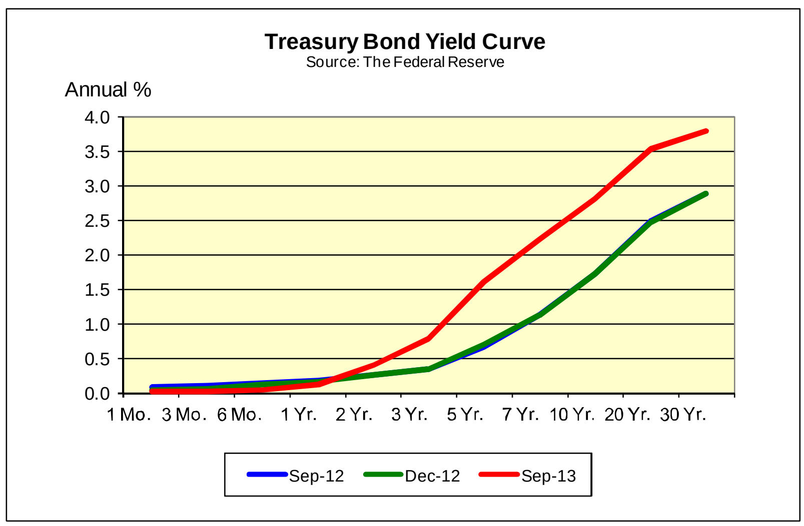
As time has passed cars have been getting better but it's been progressively harder to find a job, and wages for those precious few jobs have generally not kept pace with inflation. A great deal of academic brainpower has been wasted in trying to attribute special cyclical components to the sluggishness of this recovery, such as pointing fingers at the disincentives to hiring brought into play by healthcare reform, or blaming the special financial factors behind the latest recession. There is certainly merit to these lines of thought. Incentives matter – you make hiring more expensive, companies will do less of it. And that certainly was one big-boned financial crisis that caused long-lasting damage to both institutions and psyches. But these short-term factors are more aggravations to long-term trends such as globalization and technological disruption that are the real drivers of our current malaise.

At the risk of this analysis hitting a little too close to home, it's really a jungle out there. You may have read of unfortunate demise recently of an intern at Bank of America's London office who apparently worked himself to death. The young man worked three days consecutively until 6 a.m. and just collapsed. It's come to this – people work god awful hours and put their health at risk for an *internship*. When we first entered the workforce in the early 1980s, resplendent in our K.D. Nickel Sansabelt slacks and a shiny polyester tie, people honest to God used to leave the office for lunch. For like an hour. Every now and then a martini or two would be in order. This is not to suggest that those were the good old days – after all there was a reason that parts used to fall off American cars, and it may have had something to do with a good portion of the workforce being half in the bag after lunch. But there was a certain civility to the workplace that's noticeably absent today.

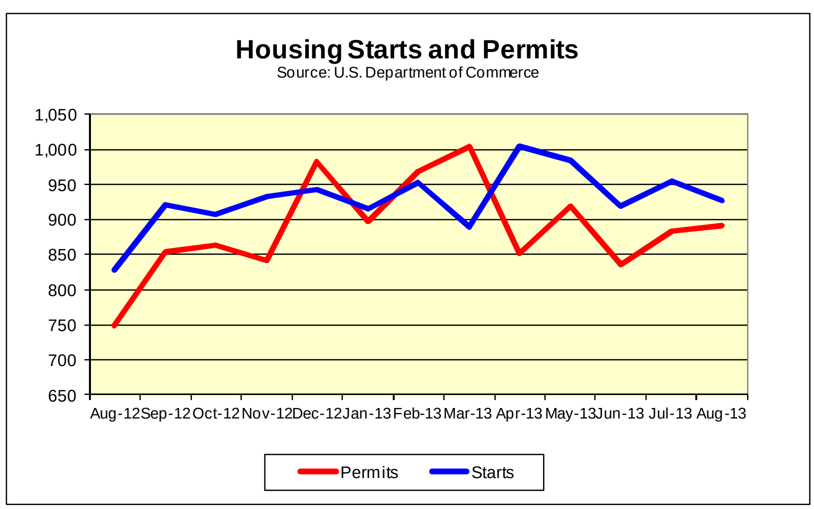


Two men can be blamed for putting us on the road to perdition (and 60 hour workweeks): Michael Milken and Bill Gates. Milken, more than any other single individual, legitimized the use of junk bond financing as a tool for corporate raiders to finance hostile takeovers. You could use the junk bonds to take over the company, fire half the workers, and usually get the same amount of work done. The numbers worked. Bill Gates, of course, legitimized the use of personal computers to do jobs that people used to do. Not to keep going all geezer on you, but in the early 1980s if you wanted to do a financial analysis on a company you had to have some funny looking paper, a powerful calculator and lots of sharp pencils. And to do the research you generally had to haul your carcass down to a library. It took awhile for the positive productivity enhancing aspects of computers to overcome the negative time suck aspects, but we are definitely there now.

The pendulum will eventually swing back the other direction, but for now the trend is still more towards trimming staff and using technology to enhance productivity than expanding market share and hiring staff. The Federal Reserve, unfortunately, has been a little slow grasping this change in workforce dynamics, which is why they've been pushing on the QE3 string trying to stimulate job creation. The metric they are using to evaluate whether to begin tapering bond purchases, and to subsequently normalize interest rates, is the unemployment rate. Which, according to Ben Bernanke (and he should know), needs to drop below 7.0%. Leaving aside the uselessness of the headline unemployment rate as a measure of the health of the labor market (another analysis entirely) they've made the fundamental mistake of using a cyclical policy tool on a market that's being primarily driven by structural changes. The measure that is most directly influenced by monetary policy is private investment, which is far more cyclical than employment and responds well to lower interest rates. At a certain point you reach diminishing returns, however, and it's arguable that we're already past that point with monetary policy on both investment and jobs.



The Fed has well and truly painted itself into a corner and as it's arguable whether the loose money is doing more harm than good. The spike in Treasury bond yields during the taper tantrum this summer, for example, has largely stayed intact even as taper prospects have fizzled. To some extent this likely reflects rising uncertainties surrounding the fiscal follies, but fear of future inflation is also creeping into the mix. At any rate, increasing rates are starting to tamp the housing market recovery, among other things. While not necessarily a bad thing



(wouldn't want another housing bubble right now, wouldn't be prudent) it is counter to the QE3 goal of providing fuel for interest rate sensitive sectors. In addition to the fiscal follies dilemma, the Fed is also facing a transition in leadership. In January Ben Bernanke will retire and be replaced (pending confirmation) by current Vice Chair Janet Yellen (a confirmed easy money advocate). It's unlikely there will be any drastic shifts in policy before then.