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Will the market rise or fall?

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The long-term outlook for the stock market is not good, and here is why. For the past 100 years, there has been an inverse relationship between changes in the size of government and the growth or decline in the stock market.

Even though the relative size of the U.S. federal government will decrease from 2009 to 2010, the trend is likely to be steadily upward from thereon, unless some fundamental changes are made.

The accompanying chart clearly shows the inverse relationship between the direction of the size of government and stock market performance. Note, the magnitudes of the stock market swings will vary according to which indices are drawn on (and hence should be used with caution), but the direction of change (after inflation adjustment) is fairly consistent, regardless of which major index (or combination) is used.

From 1910 until 1916, the size of the U.S. government remained almost constant as a share of gross domestic product. But with the entry of the U.S. into World War I, the size of government increased about tenfold from 1916 through 1919. The price level doubled (even though the Federal Reserve had been created in 1913 with an explicit charge to provide stable money) and the value of the stock market was cut in half.

At the end of World War I, Congress sharply reduced spending but still left the country with a government about three times the size it was before the war. The country suffered a severe recession in 1920 and 1921 as the Fed reined in its inflationary monetary policy, which ultimately provided price stability from 1921 to 1929. The size of government was slowly reduced during the 1920s but still remained at about 50 percent higher than the pre-World War I level at the end of the decade. The stock market boomed but, even so, did not recover to its 1909 level (in inflation adjusted dollars) until 1928.

With the onset of the Great Depression, government spending rose fairly steadily from about 4 percent of GDP at the end of 1929 to 11 percent by 1936, and ultimately to a high of 48 percent at the end of World War II. Despite some ups and downs, the stock market was about half its 1929 level and was not to reach that level again in real dollars until 1956.

Government spending as a percentage of GDP went through wild gyrations from 1945 until 1953, at first because of a rapid demobilization from World War II, and then a more modest buildup to fund the Korean War. Even so, the size of government dropped by more than half from the beginning to the end of this period, and the markets rose by about 30 percent.

The period from the end of the Korean War in 1953 to the beginning of the major buildup for the Vietnam War in 1965 was characterized by a continuing decline in the size of government, resulting in an almost threefold rise in the value of the market.

Unfortunately, much of this market gain was lost during the next 17 years, as government grew larger under both Democrats and Republicans, until Ronald Reagan was finally able to obtain a reversal in the growth of government in 1982. From 1982 to 2001, the federal government slowly declined as a share of GDP (except during the brief recession of 1990-91), and the stock market rose by a record 579 percent. The good news came to an end in 2001 as the government started growing again, first under the Republicans and then the Democrats. The result was a major drop (after adjusting for inflation) from the stock market highs of 2000 to the present.

In the past 18 months, there has been a huge bump in the government share of GDP (from about 21 percent to 28 percent). Much of the increase was due to the Troubled Asset Relief Program (TARP financial rescue package) and the various "stimulus" packages. Much of the TARP money may well be paid back, and the stimulus spending surge should wind down in 2010. This should result in a small decline in the relative size of government, which partially explains the rise in the markets in recent months.

But now, hold on. Congress is trying to add trillions of dollars of new spending for health care, climate change and assorted other schemes. To the extent Congress succeeds in passing such legislation, the relative size of government will steadily grow, which means there is a very high probability the stock market will decline in real terms over the coming years (there is a century of evidence).

And finally, Congress and the administration continue to provide government guarantees (through the Federal Housing Administration, Fannie Mae, Freddie Mac, etc.) for most housing loans. Those loans that go bad, as many will, translate into hundreds of billions of dollars of additional government spending.

Congress is the Grinch that is stealing your financial future. Happy New Year!

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