

1st Quarter 2010

TAXES, STIMULUS, INTEREST RATES

This quarter I will once again share the views of several well-known respected economists/money managers, and then I will sum their views up and share our rationale for our current asset allocation recommendations.

**David A. Rosenberg, Chief Economist and Strategist
Gluskin Sheff
(from his April 19, 2010 “Breakfast with Dave”)**

No Free Lunch

It is truly amazing how investors are missing the forest for the trees. A nascent recovery and V-shaped bull market completely premised on rampant government stimulus is going to have a payback. The day of reckoning is coming and sooner than many think.

Fixing the fiscal mess will not be achieved through spending restraint because spending is increasingly being dominated by locked-in mandatory entitlement spending and interest costs on the rapidly rising stock of public debt. Unlike the key propelling factors behind the onset of the secular bull market in 1982, which were tax reduction, less government and lower interest rates, we will see none of that going forward.

Not that the Fed will be raising rates any time soon, but they can't exactly be cut like they were in the early and mid 1980s. But taxes are going higher and on the most productive parts of society. The Bush tax cuts enacted in 2001 and 2002 expire on January 1st, 2011 – and according to our friends at Hoisington, this will total \$1.5 trillion in the ensuing decade or a 1% hit to GDP annually.

On that date, top marginal tax rates for individuals earning more than 200k and families making over 250k will see their tax rates rise to 39.6% from 35% (the current 15% rate on capital gains and dividends will also go back to 20% and 39.6%, respectively, on Jan 1, 2011).

This is all reminiscent of how the New Deal was ultimately paid for – the top marginal tax rate soared in the 1930s (before WWII) from 25% to 80%. Maybe that's why the next secular bull market didn't start until 1954.

A Dubious Economic Policy

Can there really be any doubt that what we have on our hands is a government policy that is aimed at transferring losses and liabilities from the private sector to the public sector? The latest leg to the government's bailout policy has been to allow stressed-out homeowners to refinance into the FHA – with principal forgiveness for underwater borrowers and even for those who are current!

The government is pursuing a strategy that basically transfers all the modified re-default

risk from current bond holders to the FHA. As a result of this strategy, the U.S. taxpayer is now on the hook for a potentially huge loss profile. This is obviously an incremental positive to "cash flow" for a select group of homeowners and I estimate that absent this so-called stimulus and strategic defaults (which has added as much as \$200 billion to household cash flow at an annual rate), consumer spending would be contracting. Unbelievable stuff.

Remember that the big tax grab starts on Jan 1/2011 and under current plan will drain \$150 billion or 1% out of GDP annually for the ensuing decade. That tax bill is likely to rise even further than currently planned and hit the top band of the income strata as well as investment earnings.

**James W. Paulsen, Ph.D., Chief Investment Strategist
Wells Capital Management
(from his April 2010 "Economic and Market Perspective")**

Additional Forces For Economic Growth Are On The Horizon!??

Several positive forces have just begun to promote a recovery, and while they will soon, others have not yet started assisting the economy.

The housing and auto industries have been slow to recover but both illustrate a persuasive bottom. The collapse of these two industries chronically offset or overwhelmed positive growth in other parts of the economy. Consequently, simply by bottoming, these two industries have already contributed to the revival in real GDP growth. Moreover, both industries should start growing again this year, adding to real GDP growth rather than just subtracting less.

Home prices as measured by the Case-Shiller price index have risen in each of the last eight months.

During the last three years, U.S. international trade has contributed to overall real GDP growth in nine of the 12 quarters by an average annualized rate of 0.9 percent.

The end of the "business purge" helped revive economic growth since last summer.

Finally, the massive economic policy package implemented during the crisis has yet to fully reach Main Street.

Monetary policies in particular should be augmented soon by rising velocity. Velocity is the rate at which the money supply is "turned over" into economic activity. It did rise during the fourth quarter and probably expanded further in the first quarter. However, it should strengthen faster during the rest of this year as job creation returns (boosting household borrowing propensities) and as inventory rebuilding begins (boosting business loan demands).

What About Interest Rates????

Although interest rates will probably rise in the coming months, their increase this year should be manageable. Despite stronger-than-expected economic growth, both the core consumer price and wage inflation rates should decelerate, muting bond market concerns about a stronger economy.

The 10-year Treasury bond yield will soon rise above 4 percent since the economy has returned to job creation. However, the 10-year yield is not likely to rise much above 4.5 percent this year. Core inflation typically decelerates for 12 to 24 months “after” recessions end. This is because the unemployed resources caused by the recession cap inflationary pressures for some time even as economic growth returns.

Interest rate risk may become much more pronounced in 2011, but for the rest of this year, we expect a relatively benign trading range for the 10-year Treasury yield between 4 and 4.5 percent.

The bad news for stocks? Interest rates are headed higher. The good news for stocks? Rising interest rates no longer are as damaging to the stock market as they once were!

From 1970 until the late 1990s, the relationship between stock market movements and interest rate changes was characterized by a persistent negative correlation. That is, higher interest rates were associated with lower stock prices. Since 1998, however, the correlation has been positive, implying increases in bond yields are usually associated with gains in the stock market. Consequently, since 1998, rising bond yields no longer cause stock prices to decline as frequently as they have historically. The correlation between stock prices and interest rates reflect investor fears. When the correlation is negative (i.e., rising interest rates caused stock prices to decline), inflation is the primary consensus fear and improved economic numbers often hurt both bond prices and stock prices since they suggest increased inflationary potential. By contrast, when deflation is a central focus, the correlation between stock prices and interest rates turns positive. In this case, evidence of a better economy helps stock prices and increases interest rates since it signifies less risk of a depressionary collapse.

Investors should watch for a shift in the correlation back to “negative.” This would suggest a return of inflationary fears whereby rising interest rates would again become potentially more harmful to the stock market. In the meantime, rising yields, especially from such low current levels, may prove less troublesome for stock investors.

Van R. Hoisington and Lacy H. Hunt, Ph.D.
Hoisington Investment Management Company
(from their “First Quarter 2010 Quarterly Review and Outlook”)

The federal government cannot create prosperity by spending funds that it does not have. It can, however, spend us into poverty by taking dollar balances from highly productive individuals and their business entities, through borrowing or taxing. This process of transferring these assets from income and wealth generators to other government applications has profound economic consequences.

Our read of history, economic theory, and mathematics leads us to one clear conclusion. The “taking” of funds by central government to be redistributed to other priorities is, in the end, contractionary.

Viscerally, the normal reaction to a massive increase in government spending is to assume it is an inflationary event, particularly in the U.S. where amounts have been so large over the past ten years. Has this huge spending shift from 18.4% of GDP in 2000 to 24.7% today made the U.S. more prosperous? The results are unequivocal. Inflation today is 1.3% versus 1.7% ten years ago (core PCE deflator.) The percent of the population working today is 58.6% while prior to the large budget deficit spending of the last ten years it was 64.6%. Our GDP was growing at 4.8% ten years ago, and today we are staggering out of recession.

History displays the same pattern in other countries where excessive government deficits have been implemented. The modern example is Japan. Its government debt soared from 52% of GDP in 1989 to 184% today. The economic results: GDP in that country is no higher than it was 18 years ago; its employment is no higher than it was 19 years ago, and there is no inflation since consumer prices are at 1993 levels. Thus, contrary to conventional wisdom, monumental government spending produced less growth, and lowered both standards of living and inflation.

There is no free lunch when the government is spending. Taxes have to rise. Beginning January 1, 2011 the sizeable tax reductions enacted in 2001 and 2002 will expire. The administration projects that household taxes will rise by a cumulative \$1.1 trillion over the ensuing ten year period, while business taxes will rise by \$400 billion. This calculation was prior to any taxes enacted in the healthcare bill, and does not account for other taxes such as the recently mentioned value added tax suggested by administration policy advisors. Dr. Barro, a Harvard economist, estimates that the tax multiplier is minus 1.1, meaning that a \$1 increase in taxes will reduce GDP by \$1.10. However, Christina Romer, Chair of the Council of Economic Advisors and her husband David in an exhaustive study published in March 2007 found the tax multiplier to be -3.

If we apply these two multiplier estimates to the repeal of the 2001 and 2003 tax cuts, the drag on economic activity will be between \$1.65 trillion and \$4.5 trillion. Bottom

line, if the spending multiplier is .6 and the tax multiplier is at least 1.1 or higher, then mathematically this country cannot spend its way to prosperity.

History

The multiplier analysis is also confirmed by numerous experiences in U.S. economic history. On the positive side, the major tax reductions initiated by President Kennedy in the early 1960s gave economic activity a major boost, just as did the similar reductions by President Reagan in the 1980s. To deal with the depression that arose after World War I, President Harding cut taxes and government spending, keeping the federal budget in balance. The 1920 depression ended quickly and prosperity returned. Tax increases by Presidents Hoover and Roosevelt in the 1930s had a negative impact on growth.

Fiscal Policy: The Net Effect

History therefore suggests that cutting taxes tends to boost GDP while raising taxes has the opposite effect. Economic theory suggests that increased government spending can boost economic activity for a time, but the additional borrowing and subsequent tax increases reverse that short-term boost, resulting in lower total output for the economy. The mathematics of these two variables, spending and taxes, suggest the inevitability of a contractionary outcome if there is a massive shift in funds from the private to the public sector.

Asset Allocation

As you can tell by the comments of these three firms there is a wide difference of opinion about what is ahead in the economy and the markets. All support their views with data and logic. At Monroe Vos we rarely suggest taking an absolute position about the economy and the market. We believe it is prudent to be in the middle to different degrees. This is why we continue to suggest tactical asset allocation to 40% stocks and 60% bonds. The stock market can continue to gradually rise or it may correct as we get closer to the tax cuts expiring. When taxes go up, history shows that the economy slows down because those that pay taxes to the government won't have as much money to spend in the economy. This is a concern along with the slowing of government stimulus and an eventual increase of interest rates by the Federal Reserve. All of these may have the affect of slowing down the economy.

Recommendations

Endowments, Foundations, Defined Benefit and Profit Sharing Funds

We continue to recommend the 40% stock/60% bond asset allocation at this time.

High-Net-Worth Individuals

We recommend between 20%-40% stocks and 80%-60% bonds based on the individual risk tolerance and cash flow needs.

Corporate Operating Funds

We recommend a 20% stock/40% bond/40% short-term fund allocation.

401(k)/403(b) Plans

We recommend that participants in these plans allocate their assets according to their risk tolerance and time horizon. Most plans have the Asset Allocation Strategies available. We suggest staying the course, rebalancing, and continue to dollar-cost-average with new contributions.

We look forward to seeing you at our next meeting.

Jamison Monroe, CIMA®
Chairman & CEO
Director of Corporate Values

Please visit our website at www.monroeivos.com.