

Impressions

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Taxation and the Flight of Capital

“The biggest cause of trouble in the world today is that the stupid people are so sure about things and the intelligent folks are so full of doubts.”

Bertrand Russell

“He who knows nothing, doubts nothing”

Spanish Proverb

So what gives with the Market

Since March 6 the markets have rallied about 35% and the natural questions are: Has the market bottomed? Is the worst over? Has the financial crisis ended? There are a number of noted commentators who are worthy of respect, such as Larry Kudlow and Steve Leuthold, whose answer is yes and that a new bull market has started. I have known Larry Kudlow for 20 years and he has never failed to be bullish. The underperforming Jim Cramer and a few others join them.

What you believe about the markets at this juncture depends on your perspective. One school of thought believes that we entered a bear market in 1999 and the decline in 2008 was the final paroxysm of that 10 year cycle. The other school believes that a bear market started in late 1999 early 2000 and ended in 2004. This was then followed by a bull market that lasted until 2008.

Can both camps be right? The answer sadly is yes. Market moves are often divided into secular moves and cyclical moves. Secular tends to be longer in duration and have greater percentage moves. An example of a secular market would be the 1920's and the late lamented 1990's. Within secular bull and bear markets cyclical moves of relatively long duration and move large percentages can occur. While there were cyclical bull moves in the 1930's the overall secular trend was down (bear).

Cyclical moves usually start with valuation extremes. Two causes usually precipitate secular markets. First is a basic change in the economic structure. The second is a correction of excesses caused by an opposite secular moves. In the past, markets have reverted to their mean performance by under performing, which is how means are created. In history it is not normal for a market to produce returns consistently far above the mean as was the case in the 1990's. That there were no corrections substan-

tial enough to address the structural imbalance for almost 6 years made it almost inevitable that there would be some years in which returns would be miserable.

The more complex reasons for the beginning of secular bull or bear markets are changes in the underlying economic assumptions. These myriad changes are usually subtle at first. For example at the end of the 1970's, a miserable ten-year period, several things began to happen. Governments in the developed nations began to move from center left to center right (Reagan, Thatcher, and Kohl) who were friendlier to business. These center right governments began to realign the relationship of government to the taxpayer. Their reduction in government control unleashed the long suppressed optimism of their populations. Hume and later Keynes called this the "animal spirits of the economy". OPEC nations had been draining the wealth of the west with higher oil prices but found that they had few options to reinvest the money unless it was in the developed nations so their interests became aligned with the West instead of at odds. OPEC's distress was caused by the fact that the dollar was the unchallenged reserve currency; oil was priced in dollars so their customers directly controlled the value of their revenue.

Monetary policy makers realized that inflation had done enough damage and began to take the hard steps necessary to defeat it. Finally corporations had redressed the excesses in leverage and poor investments that had been made during the great period of conglomeration of the 1960's. The result was that beginning in 1982 the US market lifted off in a secular move that was to last until the end of the 1990's. It was punctuated by several cyclical bear corrections such as 1987, 1991 and 1994. Starting in 1995 the market entered what is generally known as a blow off phase in which the most preposterous stories and companies find investors.

The move up from what is being called the March 6 bottom was lead by financial stocks and a few other sectors. It is also interesting that it started with the release of earnings that were less miserable than predicted. One could argue that many earnings were in fact manufactured and dependent on chimerical situations. Much was made of Citicorp's profit. However if those numbers are deconstructed it can be seen that Citi never slept in finding ways to massage the numbers. They took advantage of a onetime provision related to their debt outstanding. Because of the mess they have made of the franchise, the price of the company's debt had declined so Citicorp got to treat the decline in value as if they had purchased it at a lower price. They never purchased a dollar of the debt. They just created a make believe number which offset all the actual losses they took. The company really made no actual money in the quarter, it was all made up! To the casual observer seeking some good news this was so different from the predicted losses that the stock moved from 2 to 8!

They were not alone in all this stuff, few of the banks made actual money. The credit card companies made money only from the low cost the TARP funds they received. At the same time credit card write offs (that is accounts that are total losses) rose to 8.8% of total assets! The highest in history! Here is another conundrum. Not one of the management teams of the banks and credit card companies has lost their jobs. Sure the government seized Freddie and Fannie and AIG and fired their top management but the same folks who gave us Citicorp going from \$50 to \$2, and B of A going from \$45 to \$6 are still

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there and still in control! The President fired the chairman of GM, however. Maybe if Wall Street was unionized some folks might have been fired.

The silliness has not stopped yet. The Treasury conducted a “stress test” and found that banks with a Tier One Capital level of 9% are not properly capitalized. They have decided that a capital level of 4% is more appropriate. What you say how this can be true. At a 9% capital level the bank is leveraged 11 to 1, at a 4% level the bank is leveraged 25 to 1. Less than six months ago a bank with 4% capital level was consider a candidate for seizure!

The fact is that nothing has changed. There is more liquidity in the system (if there wasn't it would be something weird given all the governmental actions). Interest rates are still low and the key short-term interbank lender rates are low and heading lower. Unemployment is still rising (see this link <http://www.slate.com/id/2216238/> for an interactive map showing job losses) and, yes, I know that it is considered a trailing indicator, but no recourse loans such as credit card debts are the first thing that will not get paid when a person loses his job. Houses are still declining in value. Yes, the rate of decline seems to be slowing, but that could be same situation as a person who is bleeding to death suddenly experiencing a stabilization of blood pressure. There is no blood so the pressure stabilizes. Houses are not declining in price because they are no longer being offered as aggressively in those areas under the greatest pressure.

Finally, oil is up in price, gold has broken out, commodities are moving up and the US dollar is falling against virtually all the major currencies. The rally has largely centered in the banks, diversified financials and energy. One of the things that end rallies is the occurrence of a major spate of stock offerings. These stock offerings are being done under the rubric of repaying the TARP funds but here are several questions you should be asking. Arguably the management of the issuers is the best informed about the true conditions of their bank. If that were true, why you would want to be the buyer of their sales? These people are not known for selling cheaply. If things are so rosy why are they selling at hugely dilutive prices? When was the last time Wall Street issued anything that was in your interest as a buyer? Wall Street does not work that way. If they are selling it is because they benefit, not you. The counterpoint is that the buyers are largely sophisticated buyers and they know what they are doing. By sophisticated you mean the same folks that could not get enough subprime structured securities 14 months ago? Those guys? The banks have been offering shares like there is no tomorrow and perhaps for them there isn't. All of this is not compatible with a long-term bull market.

My advice here is to be very careful and do not chase the extended stocks.

TAXATION

In our last newsletter we discussed the fact that the financial market collapse was likely to lead to a new regulatory regime for the investment industry. If we believe the press, that process is already underway. We also believe that other areas of the economy will come under a new and much more stringent regulatory scheme and that process is moving ahead. Under the rubric of challenging climate change there is a 485 page bill moving in Congress that even the Chairman of the committee sponsoring the bill admits he has not read and has no idea of all the provisions! This bill will affect over half of the economy!

We also stated that we believed that a major increase in taxation was nearly inevitable. A number of the states have already indicated that they intend to increase taxes on what they call "the rich". The way they define "rich" you could easily be one of those evil people.

<http://online.wsj.com/article/SB124260067214828295.html> :

<http://www.therealestatebloggers.com/2009/05/19/how-high-tax-states-drive-out-the-rich/>

<http://www.nytimes.com/2009/01/21/nyregion/21millionaire.html>

http://boortz.com/nealz_nuze/2009/05/taxing-the-evil-rich.html

Most of the tax increases are aimed at relieving the distress being felt as property taxes and other revenues sources decline. There are two new reports (discussed below) that talk about the enormous needs of the federal government.

I am not talking about the current deficit spending or the increase in the national debt currently in the news. Given the size and the power of the US economy, those problems could be disposed in a few years if growth increases and we get folks back to work. Provided of course, that with all the spending and tax increases the economy still has the ability to grow. Increases in taxes and rising regulatory compliance costs reduce the capital in the economy. They also remove the animal spirits of the populace since the proceeds of their efforts produce less and less reward to the wage earner.

Hauser's Law (http://en.wikipedia.org/wiki/Hauser's_Law) indicates that regardless of what the marginal tax bracket is or has been federal revenues have remained about 19.5% of GDP. See (<http://online.wsj.com/article/SB121124460502305693.html>). What this means is that when taxes are raised people and companies find ways to avoid or forestall taxes. This can be done by shifting assets overseas, taking advantage of tax credits and not moving assets around so they will not be taxed. This is not the rantings of a conservative, it is a behavior observed in all economies and all administrations and all economies.

As an example, the State of Maryland recently imposed a tax on those making income of one million dollars or more. For the tax year 2008 (before the tax) there were about 3,000 tax returns that qualified for the new top marginal tax rate of 6.5%. To review the top marginal rate means that one you reach

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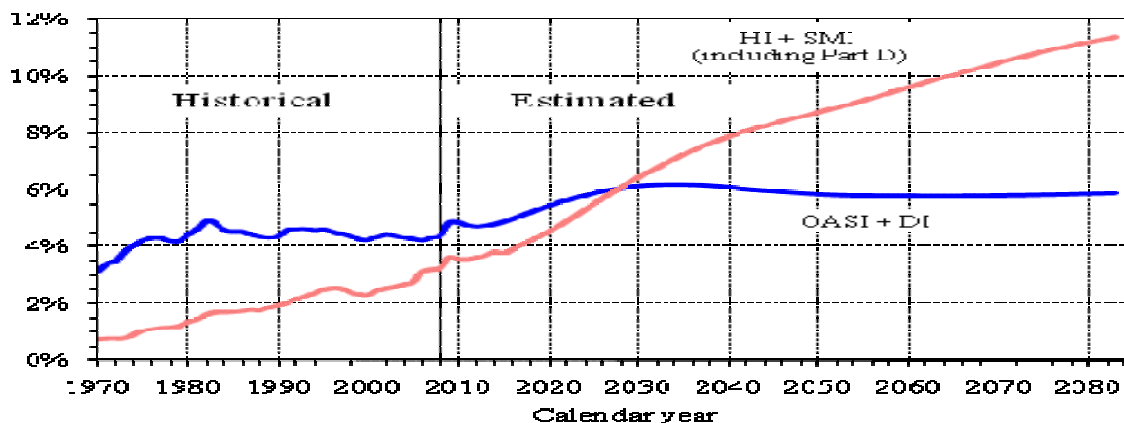
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the million dollars level the next and any other dollar is taxed at the marginal rate. It is not hard these days to end up with a million dollar income. The exercise of stock options can do it. Since the tax has gone into effect the State Comptroller's office estimates that the number has dropped to 2,000. According to this Wall Street Journal editorial (http://online.wsj.com/article_email/SB124329282377252471-1MyQjAxMDI5NDIzNjlyOTYyWj.html) the state has lost \$104 million in tax revenue. All that was necessary for these folks to reduce taxes was for them to declare residence at Hilton Head or Kiawah Island or Florida where a lot of them probably have second homes.

The trustee of the Social Security and Medicare systems released their reports on the financial conditions of those two systems. The results were not encouraging.

<http://www.ssa.gov/OACT/TRSUM/index.html> I have reproduced two charts from the reports:

Chart B—Social Security and Medicare Cost as a Percentage of GDP



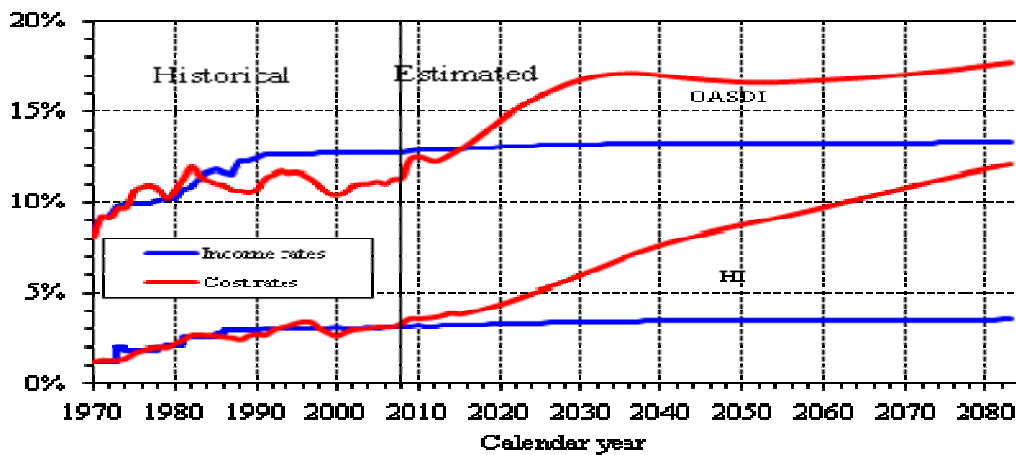
OASI = Old Age Survivors Insurance **HI**=Hospital Insurance **SMI**= Medicare Supplementary Medical Insurance **DI**=Disability Insurance

As you can see from the chart above while the costs of OASI and DI increase in the next couple of years they go flattish from 2030 on. The problem is with the HI and SMI, which as you can see explode from 2010 on reaching an incredible 11+% of GDP in by 2080!

Both social security and Medicare are largely funded by payroll deductions. The trustees then went on to forecast the payroll cost to fund the programs. There are several others methods to fund the system,

increased birth rates, a massive infusion of assets, economic growth leading to a large increase in payrolls and wages, a reduction in either the number of recipients or the size of benefits or both and finally increase the investment returns. Short of that, the only solution is to increase taxes on payroll.

Chart C—Income and Cost Rates
(Percentage of taxable payroll)



To fund the current projections taxes on payroll are going to have to go up and go up a lot. Frankly, there is no way business can be taxed at this level and still be profitable. At the current time businesses make about 11% net profit. If taxes go up to fund social security and Medicare all the profits of business will disappear. As will the other taxes business pays! So if we can accept that business payrolls cannot carry this burden alone where will the money come from?

I have maintained for some time that the seeming inability or unwillingness to stop the immigration of Latin American people is really a cynical method to increase tax income and to raise the birth rate. That will work over time but will not help the current situation. So taxes will have to go up on general income, but that still will not be enough. That means that there are two solutions, reduce the number of beneficiaries or cut the size of benefits. There will not be the political and social will to do either so the other solution is to increase taxes and inflate away the obligations. In any case, be it a regular tax or the insidious inflation tax, is going to be imposed. The only question is whose ox will be gored the worst?

As difficult as both social security and Medicare are going to be to fund the current administration has other irons in the fire. There is the current and announced funding of the auto industry as it changes from making cars no one wants to alternative fuel cars the no one will be able to afford. There will be the ongoing cost of the switch to alternative (non carbon or non hydrocarbon) fuels. There is no way any of the current technologies are economically feasible without massive support from tax breaks and direct government funding. Read that as tax revenues.

Finally there is the grand Kaunas of programs- health care. We are going to talk about the changes likely to come in that area but whatever is going to happen is going to be expensive. There are some estimates from sources in the Administration and close to the action that the least expensive program will

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cost a trillion dollars over 10 years. Not all the money will be new taxes for sure, and it is just possible that given the current mess health care financing is in that there could be savings to cover a portion of the cost.

The problem with all governmental programs is like the old saying on Wall Street about companies in trouble “the first bad news is never the last bad news.” The first cost figures out of government are never, ever the final cost figures. If government is willing to admit to a trillion it is going to be much higher.

I am convinced that unique in all the world the United States has the vitality, and capacity to do anything it wants to do for its own people. All that is necessary is the coalescence around a common principal or goal and of course that is the hard part. We have become so fractured as a people and so self centered that we may have lost the ability to unite on anything that calls for sacrifice for long enough to win through. The current Administration seems to be trying to do all things all at once. Yes it walked into the financial crisis and has had to deal with that mess, but it is attempting to fundamentally change the entire structure of the US government and the economy in a very short period of time. The President and his team feel they have a mandate to change and they are acting quickly, if not in my mind, terribly effectively, to emplace changes that will be with us for a very long time.

The rest of the world has begun to take note of the change of direction and is building in a risk premium for US assets that will haunt us. Here are the words of the highly respected Gratman Letter (www.thegartmanletter.com) concerning the dollar that is the most direct way foreign nations have to express their feeling about US policy:

“The harsh reality is ... and our friends on the Left will be angry with us for this explanation, as they always are when we move in this direction... the dollar has been falling freely and falling more certainly since Obama took control of the reins of government than it had done under the Bush Administration. We will acknowledge that the dollar was sold down at times during the Bush Administration, but the sureness with which the dollar is falling presently, and the swiftness with which it is falling, are clear and irrefutable. Money is leaving the US and is searching for homes elsewhere where it believes it can and will be treated better. Capital flees from hostility to surety. That is what capital has always done, and that is what capital will always do. At the moment, capital believes in the aftermath of the Obama Administration’s decision to replace management at various corporations; at the decisions to raise taxes; at the discussions about raising other new and larger taxes; at the policies contrary to shareholder rights, and

now with the promotion of a far left-of-centre jurist to the Supreme Court that may eventually render decisions anathema to capital creation, capital wants out! Like a battered wife that has finally had enough and chooses to leave her battering spouse, capital is packing its bags and leaving. We cannot blame it for doing so. We ought to be doing the same.”

Many of our readers are of a different ideology and believe that all this can be accomplished. The world, a majority of Americans and this writer want there to be meaningful changes in the system. The problems are easy to see and the impetuosity of youth often leads to a rush to solve problems all at once that can be very wasteful and ineffective. This rush is harder to resist when there is a political agenda associated with the reforms and politics is a game of compromise so solutions are likely to resemble a camel as opposed to the thoroughbred horse envisioned. The size of the problems is daunting and it takes a bold soul to tackle them but they need to be tackled. While all that is true there is one undeniable fact. Be you socialist, communist, Democrat, Republican, Libertarian, agnostic or something else you can't pay social security benefits, and medical benefits, or government salaries without money. At some point the cost of money gets so high that it is unupportable. Lady Thatcher once famously said, “the trouble with socialism is that eventually you run out of other people's money.” Smart lady.

The real question is what you do about all of this. I think Dennis Gartman's suggestion is a good one. You start moving to place that will benefit from the changed perception of the US. That means countries that are most like the US. This would argue for the Anglophone countries like Canada, Australia and New Zealand. You also want to look at commodity plays, their prices often moved in opposite direction to the US dollar. I would normally recommend gold but there is an anomaly going on with the price because of the influence of the Exchange Traded Funds that purchase and hold the actual metal. Gold is still a good inflation hedge but purchasing it has become more difficult. Real estate is another traditional hedge but I have a feeling the distress of the states is going to force real estate taxes up sharply. After all if you raise taxes on big houses you are just taxing the rich and we all know they don't make their fair contribution.

Good Luck,
Dennis Gibb