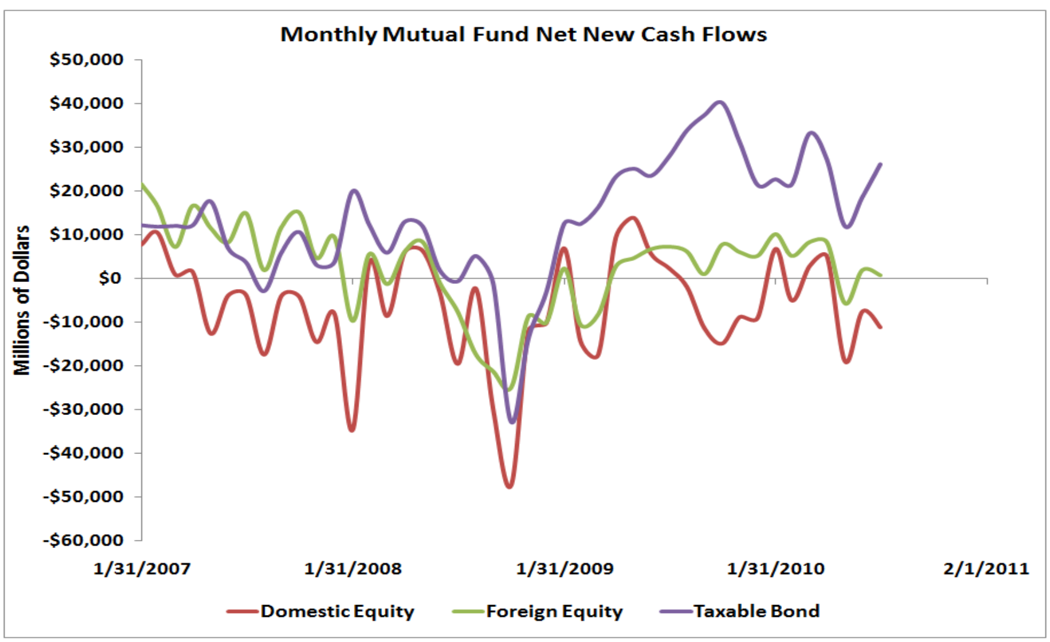
FINANCIAL MARKETS PERSPECTIVE

OCTOBER 2010

ANTICIPATING THE TAX MAN

Financial market volatility continued through the third quarter of 2010 as both investors and traders worried about the possibility of a double-dip recession and the implications of mid-term elections in November. As economic statistics failed to reflect a buoyant recovery, investors' appetite for equity investments continued to weaken and stock market averages fell accordingly. When a few favorable data points suggested the outlook was brightening, stocks rallied. Expectations of continued easy monetary policy and growing optimism about extending the Bush tax cuts triggered a rally of 8.9% in the S&P 500 index during the month of September -- the largest gain for this month since 1939. The bond market continued its ascent (up 2.5% for the quarter bringing year-to-date gains to 7.9%) as investors searched for yield. For virtually all of 2010, investors have been liquidating equity-oriented mutual funds and buying bond-oriented mutual funds in response to the uncertain economic outlook and the need to generate income given the near-zero yield on money market funds and short-term certificates of deposit (see Exhibit).



The Obama Administration has held fast to a commitment to let the Bush tax cuts expire on January 1, 2011 so personal income tax rates are scheduled to rise for most Americans next year. The rate increase means that people in higher tax brackets will see the dollar value of their tax payments go up substantially more than people in lower tax brackets. Interestingly, the percentage gain in the rate for the lowest tax bracket from 10% to 15% will equate to a 50% increase!

There are two important effects of these tax increases. First, an increase in tax rates lowers economic output as more people find ways to avoid paying these taxes if they become onerous. Second, by knowing tax rates will go up in the future, investors can plan to accelerate economic activity into lower-taxed time periods to avoid paying the higher rate. We believe that if the tax rate increases occur in 2011 there will be an artificial burst of economic activity in the fourth quarter of this year and then a plunge in economic activity in 2011 with the attendant knee-jerk response from politicians to “do something”. Without recognizing this second effect, Congress may do more harm than good as we have experienced in the past.

The politicians are also grappling with the return of the estate tax that, at 55% nationally, will undermine many smaller families who have accumulated a reasonable fortune through hard work and diligent planning. This estate tax is even higher when state estate taxes are piled on. Moreover, several states have inheritance taxes of one kind or another so “the rich” pay more taxes on income and on wealth.

Another problem that politicians face is a lack of understanding of what generates tax revenues. At some point, raising taxes on income actually reduces the total dollar amount of taxes collected. Setting tax rates at a level that maximizes tax revenues may not make sense because it means that lower-income earners would have a higher tax rate. When George Bush cut tax rates in 2003, taxes collected from the rich actually increased. In one of our recent articles, we produced the following statistics to document this unexpected outcome:

“The Wall Street Journal recently reported that in 2003, those with incomes above $200,000 paid $313 billion in income tax, and by 2007 paid $610 billion. When the recession hit, the payments fell to $537 billion in 2008. Even accounting for the decline, this is still 65% higher, five years after the Bush rate cut that was supposedly a giveaway to the rich. The share of taxes paid in the over $200,000 group in 2003 was 42% but 52% in 2008. This same group (the Obama higher tax target) accounted for just 3% of all taxpayers, but they paid more than the bottom 97%. So 3% of taxpayers paid 52% of all taxes. The Administration is concerned about “losing” $700 billion by extending tax cuts to this group, but they seem unconcerned with the "Laffer Curve" effect of increased economic activity yielding increased tax receipts from this tax reduction.”

The problem with just extending the tax cuts for one or maybe even two years creates a Damocles sword overhanging financial markets. Each time the tax deadline approaches, anxious investors will attempt to "game" the system and, in the process, upset the normal business cycle. One such example of a dislocation would be a reaction in financial markets to the planned increase in the tax rate on dividends. As of January 1, 2011 the tax rate on dividends will rise from the current 15% to 39.6% for individuals in the highest tax bracket—an increase of more than a 165%! We can imagine how investors will react to such a change in their after-tax income by selling dividend-paying stocks in search of securities whose income is taxed at a lower level. While we don't want to beat the topic of taxes to death, we want to emphasize that they are an important component of any investment strategy.

Major changes in the tax system can play havoc with financial markets. Today is no different but is more significant due to the weak economy and the prospect of a record tax increase in less than three months. In 1936, the imposition of the payroll tax and an increase in the maximum personal income tax rate to 79% drove the stock market lower while unemployment skyrocketed to 20%! Ben Bernanke, chairman of the Federal Reserve, has studied monetary policy during the Thirties and is committed to ensuring that those same monetary blunders made then are not made today. However, current fiscal policy is eerily close to 1936 and the Congress is leaning towards tightening rather than loosening measures. Our investment strategy remains sensitive to these developments and we have positioned portfolios to respond to the unintended consequences of an errant change in tax policy.

GLOBAL ECONOMIC POLICY

There are similar government policies coming out of Europe where financial crises in certain countries have tarnished the continent. Financial markets have experienced high levels of volatility as investors continue to have concerns about the overall stability of the Eurozone and some of the weaker peripheral economies such as Greece, Italy and Ireland. On the one hand, bankruptcies in the financial sector have spawned a knee-jerk fiscal policy response where cuts in government spending resulted in strikes by unions in socialist-leaning countries.

On the other hand the European Central Bank (ECB) has played a major supportive role in keeping individual countries from filing for bankruptcy. The Bank's actions were similar to those implemented by our Federal Reserve to provide a financial safety net. In the case of Europe, this safety net took the form of purchases of bonds issued by countries such as Greece and Ireland at interest rates that were low so that these countries would not have to go to the public bond market where interest rates on their bonds would have been prohibitively higher. This transitional measure was tied to the commitment by these countries to clean up their budget deficits by introducing new spending cuts or tax increases. Declining financial risks in certain economies in Europe have contributed to a strong rally in their respective financial markets.

In the Far East, the continued domination of capitalist ideals is driving strong growth in China, India, Malaysia, Singapore and Taiwan. These countries continue to flourish as individuals have high savings rates and are just beginning to enjoy the fruits of many years of labor. In our trips to Asia, we have witnessed an enormous economic expansion where people are hard-working, enterprising and desiring a higher standard of living. The acceptance and implementation of modern technology is also giving these economies a boost. An article in the Wall Street Journal described that the components of the Apple iPad come from many countries in the Far East but none come from Mid-Eastern countries. In other words, government policies can encourage innovation and wealth creation when the opportunity exists. For others who have wealth through no fault of their own, they seem to be less enthusiastic about creativity and opportunity.

An area of concern that arises when evaluating the global economy is the risk to free trade. Several countries are taking steps to reduce imports by imposing tariffs. Last year, the U.S. imposed tariffs on low-priced Chinese tires in a misguided effort to help domestic tire producers. One year later the only change was a surge in tire imports from other tire producers in the Eastern Hemisphere. However, the Chinese opted to add a tariff on imported chicken parts from the U.S. Such a tariff reduced chicken exports while increasing the price of chicken parts for Chinese consumers. With no evidence that such tariffs help and actually hurt consumers in both countries, the tariff strategy has negative consequences for economic growth.

For investors, these concerns about trade protectionism have bred a mood of pessimism that is magnified by politicians whose strategies to get elected lean on bad-mouthing the outlook for the economy. The one bright spot is corporate profitability. At last count, rising productivity coupled with modest economic growth has catapulted corporate earnings. Low interest rates have facilitated bond refinancing and lowering the cost of capital. Record cash is encouraging wealthy corporations to increase dividends, buy back stock or acquire other companies--all good omens for rising stock prices.

History tells us that investors shouldn't fight the Fed meaning that when the Fed is attempting to stimulate the economy through easy money and low interest rates, stock market rallies almost always occur. The intense focus on reducing unemployment also augurs well for continued easy monetary policy until we see one or two quarters of economic growth coupled with a sizable decline in unemployment. History also tells us that periods of pessimism usually lay the groundwork for better times ahead. Current investor negativism is reflected in the fact that equity sales in the U.S. are running at a five-year low. According to Bloomberg, equity offerings totaled $89 billion compared to $861 billion in bonds. Companies registered more than $125 billion in bond sales in September alone -- the biggest monthly take this year. Investors are buying up corporate debt despite the fact that the Barclays Capital U.S. Corporate Bond index yield was below 5.3% at the end of September -- the lowest since 1993!

As long-term professional investors, we are encouraged by skepticism about equity markets. Corporations have never been in such a sound financial position, inflation remains benign and global growth opportunities abound. Understanding that we are still operating in a trading environment that requires constant vigilance and adjustment, we remain bullish on foreign equity markets in the near and long-term. While U.S. markets may be subject to the vicissitudes of politicians in the near-term, we expect a better balance in Congress for the next two years as legislation restricting the functioning of free markets is reversed.

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