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Economic Commentary

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Killing the Goose That Laid the Golden Egg

California is the poster boy for what ails the U.S. economy. Please carefully digest the following comments made December 18, 2002 concerning the plight of the west coast state by its newly reelected Governor – Gray Davis.

> "Fifty-one percent ($17.7 billion) of this [deficit] problem is revenues, based on predictions in our current budget. Thirty-six percent ($12.6 billion) of the problem are the one-time reductions that we used last year to solve that problem. Twelve-point-five percent ($4.5 billion) are increased expenditures . . .
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> "As you well know, we have a very progressive system in this state . . . 80 percent of our revenues come from 10 percent of the tax earners. So, we depend heavily on the well-being of highly compensated Californians . . . From 1995 to 2000 these taxpayers experienced an increase in what they were providing state government on the order of about 18 percent in '95, '96, '97, and '98, and then it shot up in '99 to about 25 percent and a little higher in 2000. And 2002 they are down about 3 percent.
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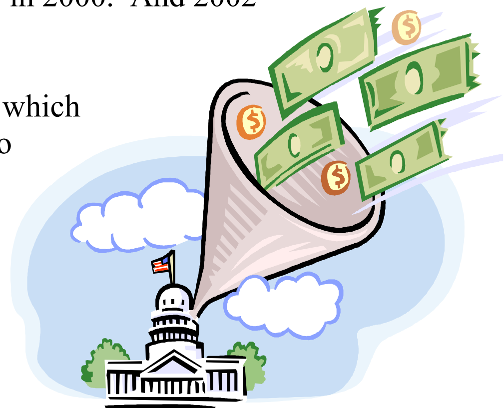
> "But when you have a very progressive tax system, which basically exempts everyone from taxes making up to $45,000 a year, and depend heavily on the performance of the top ten percent of your wage earners, then you run the risk that, if they do badly, services have to be reduced and there's not the revenue for other things we'd like to do in government. So, if there is one single problem that has caused this problem, this is it.



> "Another way of looking at it: If you just took people whose incomes exceed a million dollars, and look at the impact they've had on state revenues – again going back to '95 – it was a 46 percent increase that year in what they contributed to state revenues. '96 it was a 20 percent increase, 33 percent in 1997, 21 percent increase in 1998, 62 percent increase in 1999, 45 percent increase in 2000, and a drop off of 47 percent in 2001 . . . That's about a 50 percent drop in the revenues coming into state coffers from the millionaires in one year.
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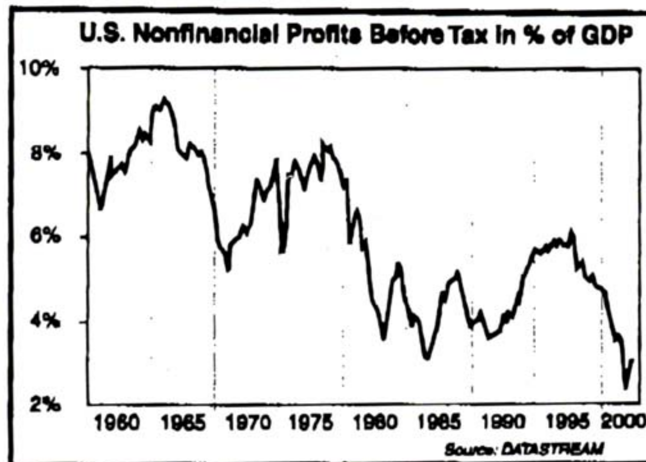
> "There's another way of looking at it, because capital gains is a big part of the problem. Obviously, people that do well invest their money. Many of their

investments are in the stock market. I've told you many times that the NASDAQ was at 5,000 in April 2000; it's now at about 1,400 - it's a 75 or 80 percent reduction . . . Here again, from '90 through '95 you have a fairly steady indication of how much money is coming into the coffers of around $20 billion. Then you have a pretty good run up from '95 up through '98, we're up to about $50 billion. But you never realize this until after the fact, but you have a spike in 2000 up around $110 billion. 2001, you're back down to $40 billionish and 2002 will be less . . . so that's another way of looking at the same picture.

" . . . Even the sales tax - which is very dependable and does not depend on higher wage earners – has diminished in recent years. Again, from '98, '99, you can see a slight trend upward to 2000, and a slight trend down in 2001. And in the end of 2001 a pretty significant [decline and] you're back to where you were in 1998 or less. And then an actual reduction in 2001 and 2002 from sales tax revenues from retailers and all sorts of taxable transactions . . . This is usually a very dependable source of revenue. You rarely see the kinds of fluctuations you do with the income tax. But we are seeing a market reduction . . .

"That shows you in a snapshot that while lack of revenue is not the only reason we are confronted with a major shortfall, it is the primary reason; that, plus the expectation that things would get better quicker last year. We had a lot of one-time solutions, and we did it in part because everyone from Alan Greenspan on down was saying 'The economy will recover . . . it will recover in the spring of 2002. In the worst case in the summer of 2002, but it will recover.' And so we didn't want to savage health and welfare programs and knock people off of programs for which they are eligible, when we think the economy is going to bounce back that quickly. Now, the finance department has its conference with a number of financial experts and the consensus now is that it will be very unlikely there will be a recovery in 2003 at all and we'll have to wait until 2004 . . . But now we are faced with a very different situation and you'll see when I make my budget plan on January 10th, with a very different response."



Note: Governor Davis, don't blame everyone else, profits have been going down since 1997. It was there for all to see.

Since the New Deal days of Franklin Roosevelt, it has been public policy to "soak the rich" to pay the rest of us. From time to time there have been reprieves – i.e. John Kennedy and Ronald Reagan – but by in large both parties have been engaged in this stupid economic policy, Democrats vocally and Republicans quietly. We are hopeful that President Bush will come with a package of tax cuts, which will benefit those who create jobs – entrepreneurs and corporations. Giving tax cuts to all others will not correct the economic problems. This may be poignant, but it is necessary.

In our opinion, the only thing that will help in the short run is tax cuts. Monetary policy will not help in any appreciable way until fiscal help comes to those who invest and create jobs. It is rarely said in Washington, D.C. or on Wall Street, but the truth of the matter is that killing the goose that laid the golden egg has been in place for seventy years and the brick wall we have all feared has finally been hit. The productive sector of our economy desperately needs relief.

There continues to be a rather large body of opinion that inflation is in the cards. We are seeing commodities and gold become the beneficiaries of this position, however, we find it to be wanting. Gold could well be rising for a much different reason in that it is the ultimate currency in a world that may get into a devaluation begger thy neighbor policy. But if one defines inflation as a general price level increase – then forget it – that will happen someday, but not in the foreseeable future. Slow to no growth plus a declining aggregate price level is our future – at least for several years. Only when we have significantly reduced debts levels will we have the wherewithal to grow the economy out of this period of stagnation.

At most, we would guess that the economy will grow at no more than 2 percent next year – that's on a nominal basis – it might be 3 percent on a real basis. We really see no quick fix. Over time, if we give tax relief to those who count the most in the economic equation, save money by paying our debts, and keep monetary policy easy, meaningful recovery will take place. A government deficit, which will continue for some time, is not a problem, it will take care of itself, *if* we take care of the private sector that pays the future taxes.

Common Stocks

This market remains grossly overvalued. We understand that it could become more so, but whether it does or doesn't, it remains a place not to be. It appears S&P 500 earnings in 2002 were approximately $30 per share up from $25. Next year maybe it can be $35. Such an increase would make the forward P/E be 26. How does this compare? The long-term average has been 15, the highs in 1929 and 1987 were around 23 and bear markets bottoms have tended to be around 7 to 10 at best. Regardless of Wall Street's continual buy and hold recommendations, it just doesn't make sense to own stocks at these levels – not if you are an investor.

Bonds

It must sound like a broken record, but the facts remain the facts. Any bond of lesser than AAA quality should not be owned, that includes both corporates and municipals. Do not invest for yield. Invest for total return. The market continues to give one the opportunity to make handsome returns (total returns) in long term governments. Inflation blinded analysts are giving the rest of us an opportunity of a lifetime. They continue to recommend either stocks, commodities, or things of a tangible nature. Old habits are difficult to overcome. The "experts" who inhabit the halls of Wall Street and Academe refuse

to see the world as it really is. The equity inflation cult remains alive and well. However, this will change and when it does our position will be more than amply rewarded.

Please Keep the Following in Mind

We have had, over the past 3 years, markets that are typical of a bull for bonds and a bear for stocks. If one has been closely observing how the markets have acted over the last three years, it's notable that, for bonds, price declines are short and sharp while price advances are long and gradual. Just the opposite is true for stocks. These are characteristics of such major market secular trends. At some point, we shall see quite the opposite and that will be the sign of a sea change. This change, in our mind, will be confirmation of our fundamental economic work, if and when it calls for an increase in interest rates. The fundamentals will change first, the market characteristics last. We shall be vigilant.

A Final Thought & Look to the Future

As this is being written, the accounts that have been with us for most of the year are up approximately 15 percent to 20 percent. This has occurred even though the investing public does not believe that deflation is probably on its way. What might the numbers be if this becomes the consensus?

Further, on a preliminary basis, before audit, it appears that over the last three years we have averaged 15 percent returns per year. This compares to stocks, which have been down for these same three years as much, or more, than we have been up.

We see nothing in the cards that will change this picture as we go forward. The continued near universal belief that interest rates cannot go lower remains in tact. This is good for us. At some point – maybe this year – the light will go on for these consensus folks. When it does, 15 percent may look like a walk in the park. We urge you to stay with the program.

Central Plains Advisors

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