Infomail

January 2, 2013

If You Raise It, They Will Leave

"In 1921, when the tax rate on people making over $100,000 a year was 73%, the federal government collected a little over $700 million in income taxes, of which 30 percent was paid by those making over $100,000. By 1929, after a series of tax rate reductions had cut the tax rate to 24 percent on those making over $100,000, the federal government collected more than a billion dollars in income taxes, of which 65% was collected from those making over $100,000."

(Thomas Sowell, American Economist)

Thinking back of 2012, not fondly mind you, the highlights of the business news were dominated by Greece and the whole Euro zone fiasco, McGuinty and Ontario, the Arab Spring revolutions in the Middle East, Spanish and Italian politics, the US Election, and the US Fiscal Cliff. In other words, pretty well all political/geo-political events. It wasn't about big mergers or takeovers, or interest rates, or certainly not economic policy (because it was almost void worldwide). In fact, the Facebook IPO may have been the business headline, and it ended up being a disaster.

Yet, despite all the political distractions, markets did "OK". German and French markets, despite the Euro woes, hit highs not seen since 2007. The Japanese market hit 2 year highs. The US market was up 11% despite finishing weak due to the Fiscal Cliff. Here in Canada, due to a very weak energy and commodity sector, the TSX was up only 3%. Since January 2011, the TSX is down 8.5% while the S&P500 is up 11.5%.

All in all, 2012 was a frustrating year. The word "grinding" was in my vernacular quite a bit. It seems that way since 2007 really.

So what is the outlook for 2013? We remain in a classic post US housing bubble distribution, where deleveraging by both consumers and sovereigns is the primary objective. Corporations, for the most part, seem to have the best balance sheets in decades (they paid their penance in 2008-09). The deleveraging will most likely continue until such time as all major global debt imbalances have been fully resolved. The world is still awash with excess manufacturing capacity across labour and product markets. Because of that, deflation themes keep trumping inflation themes.

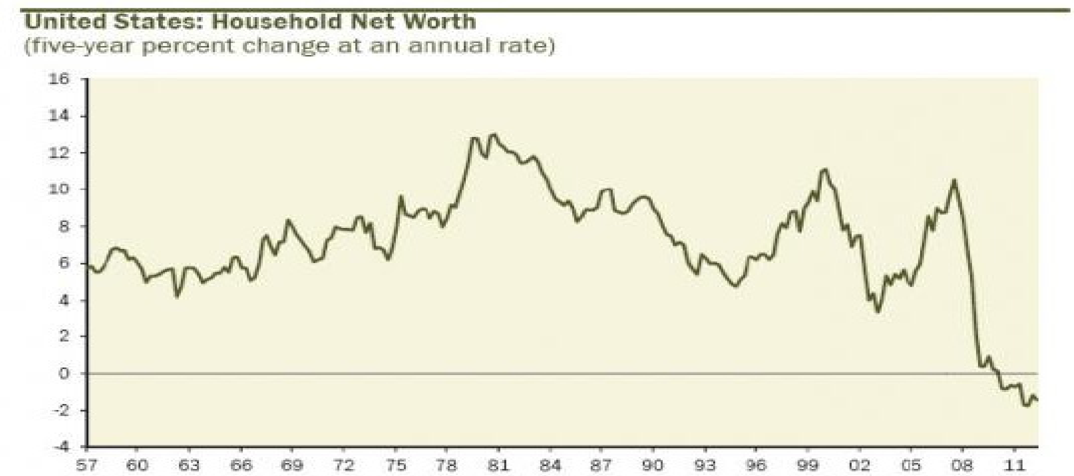
The US Federal Reserve seems intent on keeping interest rates near 0% until 2016-17, and has finally attached a benchmark target of a 6.5% unemployment rate to it. At the pace the US economy is creating jobs; it could be a decade before it gets there.

Even though yields have plunged, there is almost $2 trillion sitting on US corporate balance sheets. Real interest rates are likely to remain negative. The politics in North America seem set as well, with out PM Harper in place until April 2015 (At Least) and President Obama until January 2017.

The Federal Reserve has completely altered the relationship between stocks and bonds by nurturing an environment of a longer period of negative real interest rates. The economy and earnings remain weak, but interest rates used to discount future earnings stream keeps getting more and more negative, that lowers the corporate cost of capital and in turn raises the value of expected future profits. Central bankers are a stock market investor's best friend right now, and in 30 years I've learned the #1 axiom in investing is "don't" fight the Fed.

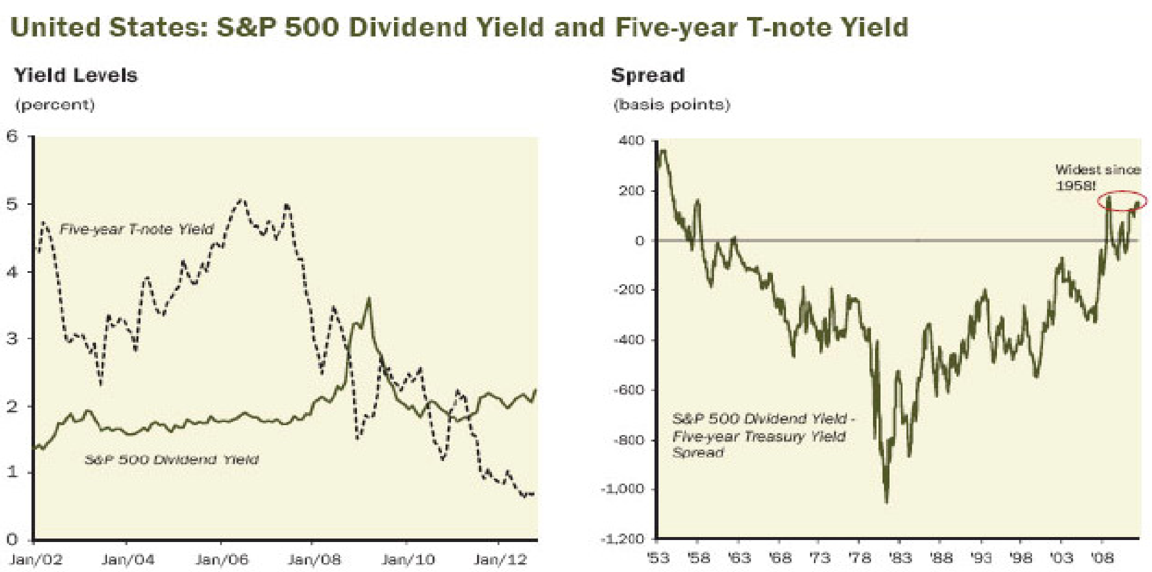
Globally, Europe seems to have stabilized, but will have many challenges for many years to come. Deleveraging among the southern Euro sovereigns (Portugal, Spain, Italy, and Greece) will be painful and stymie economic growth.

For Canada, China and its demand for commodities is the key. Recent data out of China seems to imply they may have maneuvered a "soft landing." The Shanghai index responded with an 11% gain in 10 days in mid December, but hardly anyone paid notice since the US Fiscal Cliff dominated headlines.



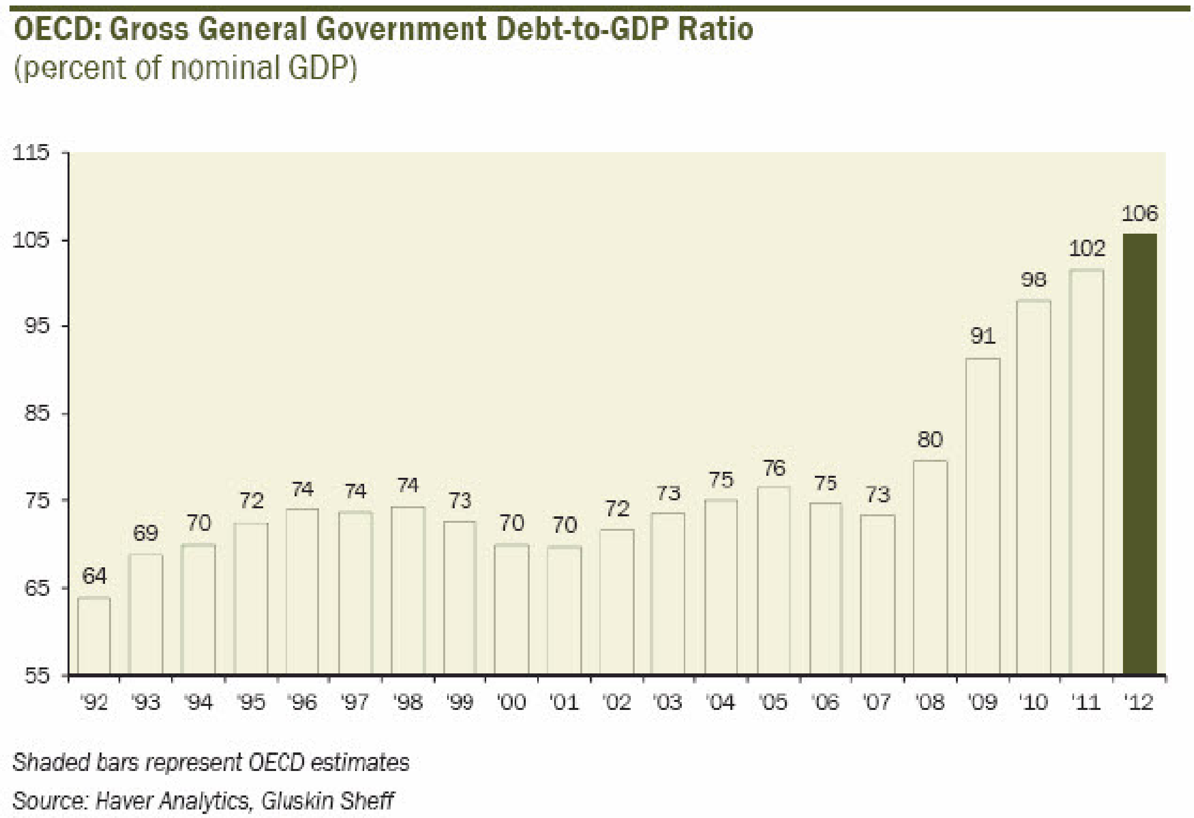
Source: Haver Analytics, Gluskin Sheff

The most compelling argument for equities is best illustrated by the chart below:



Source: Standard & Poor's, Federal Reserve Board, Gluskin Sheff

The most compelling argument against equities is best illustrated by this chart:



Now the biggest driver for the global economy will be fiscal policy out of Washington. Fed Chair Bernanke has already done everything he can on a monetary basis, so now its up to the President and Congress to do something, anything. In four years, all they could pass was Obamacare, and all reports indicate it will reduce economic growth by taking $700-800 billion out of the system.

For the bulk of the recent US election campaign, the President's only plan was to increase taxes of the wealthy as the solution to the entire nation's problems. The electorate bought that line of argument: they re-elected him. But eight weeks after the US election and there still hasn't been a serious conversation about the nation's problems. Economics 101 will tell you the US debt will become a much bigger problem when normal economic growth returns (and it will, despite current policies, because Capitalism is bigger than partisan politics) and it causes interest rates to rise, which will greatly increase the governments borrowing costs. Then they will have to deal with it in a Euro-style austerity which will slow the economy, cut jobs and increase deficits even more. Any credible deficit-reduction plans require 3 things – spending reductions, revenue increases and economic growth. They don't have to recreate the wheel. Canada showed the world how to do it in the mid 1990's.

Let me explain further with a few numbers. The USA took in taxes of $2.45 trillion in 2011, and spent $3.54 trillion, leaving a deficit of $1.1 trillion. This has been the case pretty well for each of President Obama's four years. In that period, the administration has borrowed $17,000 for every man, woman and child in the country.

Interest payments on the US debt are $258 billion. That's more than they spend on Commerce, Education, Interior, Energy, State, Homeland Security and Justice……combined.

As for entitlements, the situation is dire. The Social Security trust fund will run dry in 2033. Benefits will be cut by 25%, no ifs, ands or buts.

It's obvious to anyone who can do basic math, that the USA doesn't have a revenue problem, they have a spending problem.

Once again, I think the following chart explains it best (Figures are as of the S&P US Debt downgrade in August 2011):

The USA Economy – Simple Explanation

Why S&P downgraded the U.S.

U.S. Tax revenue	$2,170,000,000,000.00
Fed Budget	$3,820,000,000,000.00
New debt	$1,650,000,000,000.00
National Debt	$14,271,000,000,000.00
Recent Budget Cut	$38,500,000,000.00

Let's remove 8 zeros and pretend it's a household budget:

Annual Family Income	$21,700.00
Money the family spent	$38,200.00
New debt on the credit card	$16,500.00
Outstanding balance on the credit card	$142,710.00
Total budget cuts	$385.00

So the President ran on a platform that he will raise taxes on the top 5-10% and all will be cured? Really? I would say those tax increases will find a way to creep into the middle class. Also, part of the proposal on the investment side is to bring dividends and capital gains back to where they were during President Clinton's time:

	Capital Gains	Dividends
Current Tax	15%	15%
Clinton Era	20%	39.6%
Obamacare Added	23.8%	43.4%

Yes, those applied to the $250,000 level during the Clinton years, but what they don't tell you in the $250,000 level take in twice as many taxpayers today in 2012 than it did in the mid 1990's. It will take little genius to understand this President shall see his recent victory as a majority "mandate," for but four years ago, when the House Majority Leader suggested the President and Congress meet to compromise on several pieces of legislation, he was told "I won, you lost." In other words, he had no intention then of compromising, saw little reason to, and as the record shows, would not do so. I doubt with a second victory (no re-election worries) he would be more likely to do so.

Throughout the election campaign, the President talked often about a "balanced" approach, yet demands tax increases of $1.6 trillion and has yet to offer any credible spending cuts. And then proceeded to take another expensive taxpayer paid holiday to Hawaii (which ironically is where he was when the debt talks in the summer of 2011 were occurring).

The left calls for raising taxes should take some heed from recent events in France. The French decided to elect a Socialist, president Hollande, to solve their woes, and his main election promise was to raise taxes on the wealthy to 75%. Yes, you read that correctly. History has shown that if you raise taxes so much they will leave. Britain tried it in the 1970's, only to see every rock star; athlete and industrialist leave the country. Elton John, Rod Stewart moved to the USA, the Rolling Stones moved to southern France, and so on.

Even the small state of Maryland tried in 2007 to impose a 6.25% tax on incomes over $1 million. The left argued that tax revenues would rise, that the "rich" needed to pay a larger and supposedly "fairer" share of their incomes (sound familiar??), and in the end the state would be well served. Instead, and logically, the "rich" left Maryland……in droves. Between 2007 and 2010, when the tax expired, 31,000 "rich" Marylanders had left the state (Gartman Report Aug 14, 2012). Most headed to lower tax states like Texas and Florida, and even just across the river to Virginia.

In France, the process repeats itself. The proposed 75% was not just on incomes by the way, but <u>net worth.</u> Rock Stars, sports heroes, even lingerie models have already begun the exodus. France's wealthiest man, Bernard Arnault with a net worth of $41 Billion and who controls the fashion house of Dior and luxury brand conglomerate LVMH, has already declared his intent to move to Belgium. This was followed in early December by actor Gerard Depardieu, a colossus of French life, announcing he too was picking up and moving to Belgium. Was it the little Belgian truffles and chocolates that is the attraction? ...... Or perhaps that Belgium's top tax rate is "only" 50% and dropping to 45% in 2013?

President Obama's plan will not only stunt US growth, it will actually <u>reduce</u> the actual income tax intake into US Treasury coiffeurs. I guarantee it based on history.

On December 31st, millions of people around the world sand Auld Lang Syne, a song popularized by London, Ontario's own Guy Lombardo. There are several interpretations of its meaning, but essentially is a farewell or celebration of an ending.

While I am happy to see 2012 end, I worry about the future going forward when hard work and true sacrifice are greeted with contempt and punishment. It would be a shame for society to set low achievement bars and to aim for mediocrity after a century of hard work and accomplishment.

Stay tuned,

Vito Finucci
Vice President and Director
Investment Advisor

*Update – The French seemed to have come to their senses!

Early Monday morning (our time) the Constitutional Court of France rejected President Hollande's 75% millionaire tax. The Court ruled the tax wasn't acceptable because it applied to individuals, when French income taxes are generally based on household revenue. As a result, two households with the same total income could have ended up paying different rates, counter to the rule of equal tax treatment.

The ruling also lowered minimum tax rates on stock options, some retirement benefits, and bearer bonds, cutting about $660 million from the governments expected receipts in 2013. Major French companies had reportedly already begun looking into hiring senior management in London and Amsterdam.

Breaking News:

It took until the 11th hour but US Congress passed a bill avoiding the Fiscal Cliff (even though technically it happened January 1st)

Highlights:

- Postpones the $1.2 trillion in automatic spending cuts (also known as the sequester)
- Raises $600 billion in revenues through higher taxes on the wealthy ($400K per individual, $450K per family).
- Capital gains and dividend tax rates rise to 20% from 15%
- Estate tax rate raised to 40% for estates greater than $10 million.
- Eliminates alternative minimum tax issues, linking it to inflation.