CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

January 7, 2013

From 2012 to 2013

Despite the quite sullen tone from Washington in the last weeks of angry posturing by the President and Congressional leaders, and the failure of the government to resolve the self-created 'fiscal cliff' problems, the investment environment is reasonably favorable as this year begins. The legislation that was passed in the early hours of 2013 involved taxes and unemployment benefits, and deferred the automatic spending cuts, previously scheduled to begin as of January 1 for two months.

The tax legislation. As for taxes, income tax rates established in the Bush tax cuts early in the last decade were made permanent, except for an increase from 35% to 39.6% on income above $400,000 per year for individuals and $450,000 for couples filing jointly. Also restored was the earlier phase out of deductions from income for those in the high income brackets. Capital gains and dividend tax rates increased modestly for high income taxpayers, from 15% to 20%. The 2% payroll tax 'holiday', enacted after the financial crisis, which reduced individual (not employer) Social Security withholding from 6.2% to 4.2%, was allowed to lapse. This two percent reduction in take home pay will have a meaningful impact on lower income wage earners and will probably reduce economic activity by a small amount. The legislation also provided for a modest increase in estate taxes.

Happily, unemployment benefits for the many long-term unemployed, set to expire at year end, were extended for another year, a very good outcome for the individuals who receive those benefits and for the economy, since, as is likely, virtually all those payments will be spent.

Spending and borrowing; the next round. The automatic spending cuts, a feature of the August 2011 deal meant to force Republicans and Democrats to negotiate something meaningful for government spending, were postponed for two months. Thus, we are faced with another miserable set of negotiations, which will also include the raising of the 'debt ceiling', the total authorized level of debt for the United States. Treasury Secretary Geithner announced near the end of the year that the US has reached the legislated limits of it borrowing power. Work-around solutions will permit further borrowing over the next couple of months only. Republicans vow to use the necessity to raise the debt ceiling to force long-term spending cuts in Medicare, Medicaid, Social Security, and other 'entitlement' programs. Obama declares that he will not negotiate. A couple of ugly months in Washington are in prospect.

By

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Apart from politics and governance, things look reasonably good. Despite persistent uncertainties about US fiscal policy--government's taxing and spend-

ing policies--economic growth, while not brilliant, has been reasonably solid. The employment situation is improving, as is the housing market. The development of new sources of low-cost energy is spurring domestic manufacturing and exports; corporate balance sheets are very strong, and the Federal Reserve continues to provide support for the economy and the financial markets through its very accommodative monetary policy.

In Europe, the salutary effects of the European Central Bank's promise, enunciated last summer by its president, Mario Draghi, have taken the crisis off the boil. Confidence is growing that the Eurozone crisis, harmful as it is to the legions of unemployed across the Mediterranean, will not spin out of control and cause a catastrophic banking and financial markets collapse. This has permitted the extremely depressed (in relation to US markets) European stock markets to improve. Our large investment positions in Europe are prospering.

The ever-larger roles of governments and central banks. It is hard to overstate the importance of governments and central banks on economies and financial markets since the onset of the banking and financial crisis in 2008. The Eurozone crisis and America's 'fiscal cliff' problems flow directly from that crisis, although other issues (e.g., ever-rising health care costs in the US and inherent problems of sharing a currency among countries without common taxation and fiscal regimes in Europe) contribute very meaningfully to these problems. It is quite likely that Europe's current recession results from the misguided--not to say pitiless--imposition of fiscal austerity on governments, e.g., the raising of taxes and the cutting of social spending by governments. Such prescriptions are an article of faith on the political right, despite the exceptional economic weakness in the UK and in major economies in Europe that have undertaken austerity measures too soon after the 2008-2009 crisis. The relative strength of the US economy, as compared to those, should persuade policy makers in Europe, the UK and America that fiscal austerity shrinks fragile economies. But now the US is embarking on its own premature austerity. Last week's tax increases are round one; looming spending cuts in upcoming negotiations will be round two.

Apart from the economic consequences of policy judgments is their effect on financial markets and investing. One is obliged to guess the effects on financial markets of decisions that may be made and actions taken by numbers of different policy makers. Core's recent judgment about year-end 'fiscal-cliff' negotiations, namely that something would be done at the last minute to avert the worst appears to have been correct; hence our portfolios, invested in line with that view, were untroubled. Last summer, by contrast, we feared that the Euro-zone crisis, then was driving up interest rates in Italy and Spain to impossibly high levels, would worsen and create another round of widespread selling across many financial assets. We underestimated the influence of Mario Draghi's words and his contingent promises to do what was necessary to prevent the crisis. Fearing a significant market decline, we turned Core's portfolios to a defensive posture to prevent significant loss in another wave of selling. The wave of selling did not come; Mario Draghi's promises were enough, and markets rallied. Our hedging position prevented Core's portfolios from participating in the summer-time rally.

We believe that our mandate from you is two-fold: to preserve your capital and to earn a good return on it. Often we achieve both goals; sometimes our capital preservation instincts hurt the returns our portfolios earn. Politicians do not make this job easier. On to the New Year!

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