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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

By now, you have probably heard something about the so-called 'fiscal cliff,' which we are due to fall off on January 1, 2013. Simply put, taxes are set to increase, and mandatory government spending cuts are due to take hold. Oh, the humanity!

Not surprisingly, a lot of people are worried about the economic impact of this fiscal cliff, with some of the more hyperbolic among us forecasting rack & ruin. However, we need to question just what role we really, really want the government to play in our lives.

You see, an enormous amount of Federal spending is through what we call 'transfer payments.' This is when the government takes your money and gives it to someone else through some sort of entitlement program, pension, or salary. Okay, maybe the pensions and salaries aren't technically transfer payments by definition, but they have essentially the same effect. Your taxes going to provide some measure of income and/or assistance to someone else.

These types of transfers of money have constituted an enormous portion of the Federal budget deficit since 2008. For instance, in 2008, total Federal outlays were $2,983 billion. In 2011, they were $3,599 billion, for an increase of $616.billion. That is a significant sum of money, isn't it? However, during that time, purchases by the Federal government have only gone up $164 billion, and non-mandatory spending by a meager $23 billion. As such, the increase in mandatory spending & entitlements programs has been $453 billion, or roughly 70% of the total.

With that in mind, some very bright minds have forecasted the expiration of a cocktail of tax breaks could have a negative impact of upwards of 4% on overall GDP growth. That is because the increase in taxes will take this money "out of the economy." Perhaps. However, owing to the nature of the Federal budget deficit and its financing, the increase in taxes will simply mitigate our need to borrow foreign capital to pay off our entitlements programs.

This then leads us to the question: is paying off debt the same thing as saving? After all, if we reduce our reliance on foreign investors, we can come closer to self-financing, which is an admirable long-term goal, is it not?

As it stands now, foreigners have gobbled up close to $2.4 trillion of additional US Treasury debt since the end of 2008. Therefore, you can make a very cogent argument foreign investors are financing our pensioners and others on some means of governmental assistance. While foreigners have been amazingly compliant in keeping their money in the US, in the form of Treasury securities, there is absolutely no guarantee they will do so indefinitely. They can always take their marbles and go home, as it were. That is when the money truly leaves the US economy, not when there is an increase in tax rates, since most of the Federal budget is transfer payments of some variety.

True, the increase in tax receipts, or presumed increased in tax receipts, should have a depressing effect on disposable income in the United States, and that is anathema or a bitter pill for an economy so heavily reliant on consumer spending. However, anything we can do as a country to reduce our dependence on 'hot' foreign capital, is a step towards ensuring we don't continue to export dollars overseas either directly or indirectly.

Inside this issue:

"The way to wealth depends on just two words, industry and frugality."

Benjamin Franklin

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Further, since we are running a massive, aggregate trade deficit with the remainder of the world, a decrease in disposable income will serve to hopefully reduce our imbalance of trade. For instance, our cumulative trade deficit through August was approximately $500 billion. Of that, $178 billion was crude oil; another $100 billion or so was in automobiles & parts; and, finally, a whopping $220 billion in so-called consumer goods. A huge chunk of that final number can be found in clothing, footwear, toys, games, sporting goods, and televisions. Hmm, you know, stuff we really need. Basically, with the exception of cars, clothes, and crude oil, the US doesn't have much of a trade problem, at least not one to lose sleep over.

As such, it is very easy to predict the fiscal cliff will lead to a reduction in consumption of stuff we really don't need terribly much anyhow. This will, or could, have a depressing impact on earnings at consumer discretionary firms, as people squeeze another season out of their clothes, shoes, etc. Who gets hurt the most there? Well, the people who work at stores that sell, ship and market those things; they are the most directly impacted here in the US.

Of course, foreign producers will take a hit, which means those countries won't have as much capital to plow into the US. However, since we will now be more self-financing, that won't be as big of an issue as it would have been preciously. Whew….if it all seems circular, it is. Everything will essentially readjust to a slightly lower level of overall economic activity. This then will reduce overall tax receipts, and we will still have an enormous budget deficit which we have to finance, so, maybe we aren't as free from the foreigners as we thought we were.

I have gone through this exercise to attempt to prove a point: you can't simply increase taxes in order to fix your budget problems. You have to increase the pool of money which you plan to tax. That is the key! Everything else is a waste of time and money. If your pool of money is big enough, your problems magically disappear.

Tax the rich! To what end? What does that really prove? Someone you don't know has to pay more in taxes than they were previously, reducing the amount of money they have to spur economic activity? What a victory for the American people!

Imagine you own a casino. How do you increase the amount of money wagered ? The kneejerk reaction is to increase the antes, right? Sure, that might work to some extent; however, the best way of increasing the amount of money wagered in your casino is to, drum roll please, increase the number of people coming into it. In short, taking a bigger cut out of a stagnant pool of money will only get you so far, This is why you have to increase the pool. Casino owners understand this; which is why they go to great lengths to make their establishments attractive, with shows, buffets, shopping, various games and ante amounts, and the like. The hope is they will get enough people coming through the joint that they can increase the number of people playing games...which are stacked in the casino's favor. Period. It isn't magic. Steve Wynn doesn't build those increasingly elaborate places in Vegas for aesthetic appeal and kicks. No; he does it to entice you to go to it; to increase the potential pool of money coming into his casino, so he can take a chunk of it!

If all he did was increase the antes at the tables, well, he wouldn't be worth $2.5 billion.

This is what I find frustrating. Washington is so rife with bureaucrats, academics, special interest groups, and lawyers, it has a dearth of wealth generating ideas. It sees the trees, but not the forest. We must increase prices to achieve the most revenue! As opposed to: we must transform our standard operating procedures and pricing metrics to meet the changing needs of our business!

So here is what I would like to see Washington attempt, at some point in my life:

- Simplify the tax code
    - Flatten rates, and reduce deductions and loopholes. You have a pretty good idea what your tax rate is going to be at the beginning of the year.
- Forget the tax code
    - Once the tax code has been fixed, politicians can't alter it to curry favor with potential voters
- Increase the emphasis on mathematics, sciences, and technology at all stages of our educational system

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    - We don't need to be cheaper than the emerging markets; we simply need to be more productive and efficient. Greater knowledge and training will lead to greater productivity, which will result in greater wealth.

- Have our trade representatives be industry experts, not bureaucrats.
    - Sending public officials to cut trade agreements and ink business deals with foreign countries is like sending in an accountant to perform heart surgery.
- Resist imperialist foreign policy if at all possible.
    - Occupying foreign countries might make sense if you exploit the natural resources and population. However, it doesn't if you don't, and certainly doesn't add to the wealth pool.
    - Understand that sometimes the enemy of your enemy is your friend.
- Invest heavily in technology in order to reduce redundancies and increase efficiencies with public institutions.
    - We have too many arms of government doing the same thing or who knows what. Systems don't talk to each other, and the whole thing seems disjointed.
- Turn Medicare and Social Security into for profit government sponsored entities within the Federal government.
- One word: transparency! After all, we all want to know about Roswell, don't we?
    - I don't care what the rules are, I just need to know them so I can decide whether I want to play, you know?

Now, as far as I am concerned, we can work out the numbers and the specifics later; first things come first. You have to set your organization up for success in order for it to succeed. That sounds so simplistic, but does Washington think so? Is it thinking about how to grow the pool of money OR how to keep it from not shrinking? There is an enormous difference, and only one will produce the desired results.

So, in the end, fiscal cliff or no fiscal cliff. Frankly, in so many ways, it doesn't matter that much because of the way it is structured. We will simply reset at a slightly lower level of overall economic activity. This will be in economic sectors where the US doesn't have a significant comparative advantage, which will mitigate the worst case scenario and all but ensure a decrease in the number of lower end, service sector jobs created in the country. That is the end game of this fiscal cliff, little else, as Momma will still get her SS check, and Uncle Stan will continue to get his EBT, and we will still run a budget deficit.

Who knows? Maybe the clouds will part and everyone will have a meeting of the minds by the end of the year. Let me pull out my rose colored glasses and my prayer shawl, and perhaps they will.

Important Economic Releases

Release	Survey	Actual	Prior	Comments
New Home Sales (Sep)	385K	389K	368K	Nothing in this data to suggest the market sell-off we have had this week. As such, it must be a mixture of complacency, technicians, and nervous investors. Data suggests we are very close to the end of this non-sense...particularly with Apple.
FOMC	0.25%	0.25%	0.25%	
Durable Goods Orders (Sep)	7.5%	9.9%	-13.1%	
Initial Jobless Claims	370K	369K	392K	
GDP 3Q	1.8%	2.0%	1.3%	
U of Michigan Confidence (Oct)	83.0	82.6	83.1	

Tables & Data Points

STOCKS	Dow Industrials	S&P 500	NASDAQ	Russell 2000	Nikkei 225 (¥)	DJ STOXX 50 (€) Price
12/31/10	11,577.51	1,257.64	2,652.87	783.65	10,228.92	2,792.82
12/31/11	12,217.56	1,257.60	2,605.15	740.92	8,455.35	2,216.55
10/4/12	13,575.36	1,461.40	3,149.46	844.65	8,824.59	2,485.75
10/11/12	13,326.39	1,432.84	3,049.42	829.78	8,546.78	2,487.08
10/18/12	13,548.94	1,457.34	3,072.87	837.12	8,982.86	2,574.19
10/25/12	13,103.68	1,412.97	2,986.12	816.82	9,055.20	2,483.43

BONDS	3-Mo UST	6-Mo UST	2-Yr. UST	5-Yr. UST	10-Yr. UST	30-Year UST
12/31/10	0.13	0.19	0.60	2.01	3.30	4.34
12/31/11	0.01	0.06	0.24	0.83	1.88	2.90
10/4/12	0.10	0.14	0.24	0.63	1.67	2.89
10/11/12	0.10	0.15	0.26	0.66	1.67	2.85
10/18/12	0.10	0.15	0.30	0.79	1.84	3.02
10/25/12	0.11	0.15	0.31	0.82	1.82	2.98

OTHER	Prime	Fed Funds	3-Month LIBOR	Gold/troy oz.	Oil—WIT/brl.	$/Euro	JPY/$	$/GBP	CAD/$
12/31/10	3.25	0.25	0.30	1,421.40	91.38	1.337	81.19	1.559	0.994
12/31/11	3.25	0.25	0.58	1,566.80	98.83	1.296	76.99	1.551	1.017
10/4/12	3.25	0.25	0.35	1,794.10	91.71	1.302	78.48	1.619	0.980
10/11/12	3.25	0.25	0.34	1,768.80	92.07	1.293	78.35	1.605	0.979
10/18/12	3.25	0.25	0.32	1,743.30	92.10	1.307	79.28	1.604	0.985
10/25/12	3.25	0.25	0.31	1,712.00	86.05	1.294	80.31	1.612	0.995

Disclosure