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Tax Update

This article attempts to string together optimism, ambiguity and disruption.

In general, pessimistic conclusions concerning national or international financial valuations drawn from limited sample data are probably overblown fears. There is certainly reason to be concerned currently but there are so many unknowns and speculative guesses that decisive actions individuals should take are hard to visualize or justify. Perhaps the most realistic appraisal of our current situation, that we've heard, is that the election and re-election of a president with only two years experience as a US Senator lowered the bar for needed qualifications to be elected president of the United States. We're now in year nine of this experiment. The reform of medical care, financial services regulation and implementation of stimulative tax reform may actually occur. If so the financial markets may perform better than Tom Stakem predicts in this issue. If he's right however, we believe the best place to be invested in turbulent times over a complete business cycle is high quality, US equities as it was in 2000 and 2008.

If known unknowns are "uncertainties about which one can measure probability" and which are measured by volatility in financial markets, then the measure of the confidence investors have in the probabilities they use to make decisions may be called ambiguity, the measurement of unknown unknowns.[1] Seeking to measure ambiguity, one researcher analyzed market returns in 5 minute increments. He was able to conclude that both risk/volatility and uncertainty/ambiguity together have a "positive relationship with market returns". So far uncertainty/ambiguity is only calculated on a monthly basis by these researchers, according to the article. We subscribe to a service[2] that measures stock market performance in 60 minute increments daily, weekly and monthly. As the article and the service provider explain, the power to predict stock market performance is the goal. We have a ways to go.

In a recent article, a journalist suggests that the burgeoning stock market is at least in part a result of lax anti-trust enforcement in the US.[3] The author makes the point that investing in industries where the top companies were increasing their dominance versus industries where the top companies were becoming weaker would have been a good, if obvious, strategy. He closes however by warning about the disruption, eventually, of even the more dominating companies.

For a different part of the economy, however, declining enforcement of anti-trust rules is merely bending to the reality that companies live in a global market, not just a US market. Concentrated US market share doesn't matter in some industries because there are worldwide competitors moving against them. In addition, although "moats" or the price of entry into various business lines, presently, may require much capital, the disruptive trends in information technology, health care and biotechnology, energy feedstock and production, access to and distribution of consumer goods are toward smaller, quicker, better.

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We thank you for your support and want you to know that we are dedicated to serving your best interest.

William H. Darling, Chairman & President
Adrian G. Davies, Executive Vice President

[1] WSJ 3/11-12/2017 Menachem Brenner
[2] Consentio Capital
[3] WSJ, 3/4-5/2017

Fundamentals Will Trump the Economic Growth Agenda

Thomas C. Stakem

The U.S. election was largely fought over faster economic growth and individual economic freedom. Preferring 4% real GDP growth over a continuation of 2% or less real GDP growth and empowering individuals to purchase the health care insurance that met their own individual needs were themes that resonated most with the electorate.

Even in a dictatorship the rate of economic growth a country can achieve is tethered to two important fundamental economic drivers – the rate of population growth and productivity growth of the work force. The sum of these two is a proxy for a country's sustainable real economic growth rate. Add in an expected rate of inflation and that is the nominal growth "speed limit" for the economy. In the U.S. population growth is well under 1% (0.6%) and is the more easily forecasted component. Productivity is much harder as it fluctuates a lot and at its root is tied to capital investment or business capital spending. This in turn is tied to final demand, expected inflation and availability of skilled labor and tax policy. And while the long term threat (to employment) of robotics is an outgrowth of capital spending for our purposes (the next five year outlook) we're comfortable with a 1%-2% productivity growth assumption (CBO estimates 1.6% 2017 to 2047).

The CBO (Congressional Budget Office) is a resource for "scoring" the economic impact of various proposals that Congress and the Administration evaluate from time to time. In addition, the CBO is also a quality resource for researching long term economic trends and factors that underlie the revenue and expense projections for the country. The precision of numbers ten-fifteen-twenty years into the future must always be taken with a grain of salt as the variability of future trends is always more than it seems when modeled out nicely on a computer.

Infrastructure – much of the missing 1%-2% growth component

The answer to most of our economic and social problems – declining labor participation rates, declining real wages, high unemployment, inner city despair and violence - has been evident for years and it is faster economic growth. Low rates of economic growth exacerbate society's inability to address the needs of its citizenry. A 1%-2% faster real GDP growth rate, sustained over five or ten years, increases real GDP by ~$2-$4 trillion at current real GDP levels. This translates into higher wages earned, higher income taxes collected and the intangible benefits of better consumer and business confidence. In addition, a stronger economy would imply a lower level of transfer payments.

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Selected variables underlying CBO Baseline forecast

	1987-2016	2017-2027	2017-2047
Population growth	0.9%	0.7%	0.6%
Fertility Rate[1]	2.0	1.9	1.9
Immigration Rate[2]	3.8	3.2	3.2
Life Expectancy @ 65	19.3	20.1	21.5
Real GDP	2.5%	1.9%	1.9%
Nominal GDP	4.8%	3.9%	4.0%
Labor Force Growth	1.0%	0.6%	0.5%
Participation Rate	65.7%	62.0%	60.6%
Unemployment Rate	6.0%	4.8%	4.8%

	1987-2016	2017-2027	2017-2047
Labor Productivity	1.5%	1.5%	1.6%
CPI-U Growth	2.6%	2.4%	2.4%
10-year Treasury Yield	5.1%	3.2%	3.8%
All Public Federal Debt	5.2%	2.7%	3.4%

[1] Children per woman

[2] Per 1,000 people

source: CBO, "2017 Long Term Budget Outlook", March 2017, p. 30

However, a country has to be laser focused on achieving a goal of faster growth and this means a majority needs to desire the same end result. It cannot be as fractured, as the U.S. now is, with personal or political party agenda counting more than what's best overall for the country. Regrettably, Washington may not be up to the task.

Any strategy for near doubling the real GDP growth rate of the economy has to have infrastructure as a major driver, occurring atop the regular functioning of the economy as we know it. That would imply an economic environment teeming with opportunity – high paying, high skilled work for those qualified would be quite evident and this would act like a magnet and pull-up others. One can only imagine what the backlog of such infrastructure work might look like – the nation's highways, airports, ports, federal & state office buildings, public transit systems. There has to be a vast, multi-year inventory of things that could be done that would benefit the country well into the future. The capital investment cycle would be heavy for five-ten years but the economic payback would be over fifty or a hundred years. The employment effects would be obvious and local to many communities. However, it is clear that the country couldn't afford it given existing budget deficits and the out year outlook for even worse deficits even before any currently being discussed tax reforms are enacted. Without the program being heavily, if not totally privately financed, it will never score well with the CBO and Congress would vote thumbs down.

Figuring out how to finance it requires creative thinking. The potential for a win-win solution is also self-evident. Long duration high yielding instruments would be highly attractive to institutions with ALCO (asset/liability) matching requirements and individuals, particularly potential retirees. Following nearly a decade of suppressed yields many investors would scoop up a 25 or 50 year fixed-income-like investment vehicle that had a 4%-5%-6% yield attached to it. The return could be very competitive with higher risk equity returns particularly as prospective equity returns have declined to single digits. Twenty-five to fifty year infrastructure participation notes with 4%-6% yields would fund the expenditures and return a large segment of the population to the saver class after the last decade of yield suppression. Infrastructure participation notes could work like TIP (Treasury Inflation Protection) securities offered by the Treasury Department or the banking system. They essentially would be a source of U.S. government off balance sheet financing of infrastructure projects. There were rumors during the election campaign that Treasury Secretary Mnuchin might have some creative ideas in this area given his background and experience. We shall see on that score but no doubt success on other aspects of the new President's agenda will have to be seen well before this private or quasi-private funding idea gets any traction.

Without a consensus imperative to pursue much faster economic growth policies, any infrastructure investment vehicle idea like that referenced above is strictly academic. The sustainable U.S. economic growth rate is in the 2% range, based on population growth and productivity. Material incremental growth above that requires, in our judgment, pursuing large scale infrastructure investment. This now appears highly unlikely because of the division in Washington, DC. Infrastructure participation notes, as we have coined them, will thus remain an intriguing idea but nothing more.

Sobering tax facts

Perhaps because of having filed our income tax return or the timeliness of tax reform discussions in DC, a recent set of tables from the Internal Revenue Service (IRS) caught our attention and merited some analysis and reflection (see chart on the following page). IRS receipts are the thick red line, plotted on the left Y-axis scale, while the seven constituent parts to those collections are plotted in percentage share terms on the right Y-axis scale. Only three (Individual - blue, Employment - orange & Corporate – green are material enough to be readily seen.

IRS receipts, \$3.3 trillion in 2016, have increased 36-fold since 1960 (7% per year) and yet the U.S. is running a ~ \$600 billion budget deficit.

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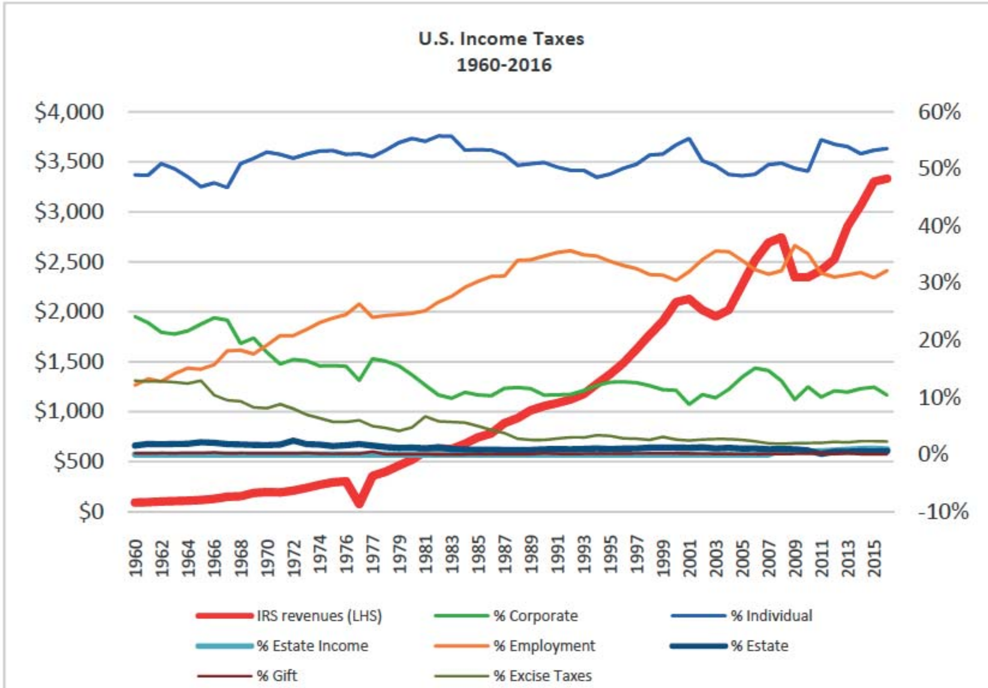

source: Internal Revenue Service 2016 Data Book, Table 6, p. 15

One could probably count on two hands the number of times Uncle Sam's revenue take was adequate to cover the spending habits of our politicians. It was somewhat eye-opening at first that Individual income taxes and Payroll (Employment as IRS terms it) taxes generate 86% of the IRS' total receipts. The Corporate (Business in IRS parlance) tax brings in a meager 10% of all IRS income. With Individual (54%) and Corporate (10%) tax components both up for reform (tax rates being cut) one can only imagine what the IRS receipt make-up will look like in the years ahead. Continued Payroll tax "creep" would seem like the only solution.

Letting it sink in that Individual and Payroll taxes contribute 8.6x that of Corporate taxes reinforces a belief that it is the Individual tax payer's "job" to pay the bulk of the taxes to run the government and that is best accomplished by having the government create the best possible economic and regulatory environment for its citizens to be employed in high paying jobs created by the business community. This is accomplished by sound fiscal policies, a competitive tax rate environment vis-à-vis trading partners and a pro-business regulatory environment. This sounds like a lot of what we heard during the President elect's campaign. We wouldn't quarrel with those who insist that individuals pay all the taxes and that corporations are merely collection agencies for the taxes that their consumers pay as part of buying their products or services.

Conclusion

Stocks are up several hundred S&P points since the election, perhaps 2 P/E multiple points, on the prospects for reduced taxes, lower regulation, faster economic growth and better paying jobs. The odds of expectations being met or exceeded seem slim given a natural economic "speed limit" of ~2% real GDP growth and the unlikelihood of enough Congressional cooperation to implement the tax and economic stimulus program that could produce higher growth. Executive orders alone will not dramatically change the growth trajectory. As a consequence investors will likely have to throttle back their EPS growth expectations which would ripple through to even the pace of Federal Reserve rate hike actions over the next year.

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In the herculean effort to collect tax revenue each year the U.S. does a reasonable job, especially compared to many southern tier European Union countries, where citizens don't appear to believe in paying taxes. According to the US Treasury, tax revenues in the first four months of FY2017 (October 2016 to January 2017) were $1.085 trillion, up very slightly from the same year earlier period.[1] However during the same period the government spent $1.242 trillion for a $157 billion deficit. Tax revenue comes mostly from individuals either through the income tax ($550B/$1,085B) or social security and other employment taxes ($362B/$1,085B). Corporate income taxes and duties collected on imports make up almost all the rest. Where does it go? A recent article on that subject described the US as a "giant insurance company with an army".[2] Half of all spending is for social security and medical benefits programs and 20% is for military.

Many pessimistic retirement income analyses for individuals take into account the assumed inability of the federal government to run deficits forever and the Census Bureau's household surveys of US individuals' income. Alternatively, an optimistic study of income tax data covering 5 years for individual tax payers from the year before they claimed social security shows that for 75% of the 16.4 million people who were between 55 and 61 in 1999 the "median retiree managed to replace 103% of his or her pre-retirement spendable income".[3] The Census Bureau data includes the 25% of the specified age groups who were not working and are not included in the optimistic income tax data set.

The authors conclude that "the programs we have in place are working", and recommend that policy makers focus on "shoring up social security's financing and helping people unable to save due to disability or frequent spells of unemployment." The optimistic research found that for those in the bottom 20% of earners retirement income rose to 123% of pre-retirement income mostly due to the progressive benefit formula of social security. It is hard enough for policy makers to put policies in place that don't create more problems than they solve, especially if they are working with erroneous assumptions and studies.

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[1] CNS news.com 2/13/2017
[2] WSJ 4/15-16/2017
[3] WSJ 4/22-23/2017

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