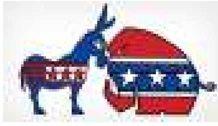
Election



I cannot tell you how glad I am the election is over. I grow weary of things when the media talks about them non-stop. The last month or so, you could change the channel five times and find discussion about the election on every channel.

Add to that, the persistent notion that whatever the president said today is the top national news story or near to it, every cotton-picking day of the year. I don't care where the president campaigned today or what his wife wore or what five different panelists have to say about the same thing they talked about yesterday. Give us a break! How about some real news? Paul Harvey, where are you?

The fact that President Obama is reelected does matter, though, and on a number of fronts. Presidents normally don't accomplish that much in a second term but I think this will be an exception. For starters, let's talk about the so-called Fiscal Cliff.

Fiscal Cliff

According to the virtually unanimous opinion of the media, not re-doing the deficit reduction agreement agreed upon last summer will be the end of civilization in the United States. At least, it will be the end of what little prosperity people enjoy today and a sure trigger for another recession. It seems every economist that can be found to talk about how many points of growth will be deducted from our growth rate has gotten some press or air time.

I know it's hard to believe that the media and Washington politicians can overstate something (other than the obvious) but I really think they really need to stop hyper-ventilating on this one.

The reason I think their concern is overblown is that half of their prediction relies on the same Keynesian economic model that has failed in the last few years. That model predicts that changes in government spending, or lack thereof, have big effects on the economy.

90% Debt/GDP = Threshold Above Which GDP Suffers

US Federal Debt Presently **102%** of GDP

Real GDP Growth as Level of Government Debt Varies				
Select Advanced Economies (1790-2009)				
	Central (Federal) Government Debt/GDP			
	Below 30%	30% - 60%	60% - 90%	90% and Above
Average	3.7	3.0	3.4	1.7
Median	3.9	3.1	2.8	1.9
# of Observations	866	654	445	352
Select Emerging Market Economies (1900-2009)				
	Central (Federal) Government Debt/GDP			
	Below 30%	30% - 60%	60% - 90%	90% and Above
Average	4.3	4.1	4.2	1.0
Median	4.5	4.4	4.5	2.9
# of Observations	668	450	148	113

SCHWAB

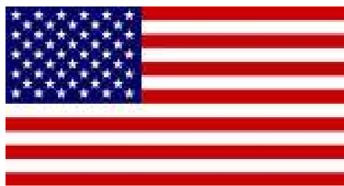
At right is a Schwab summary of part of a very important paper published a few years ago (Reinhart, Carmen M and Kenneth S Rogoff (2010b), "Growth in a Time of Debt", *American Economic Review: Papers and Proceedings*, 100(2):573-578), showing the effectiveness of government fiscal stimulus (government spending) at varying levels of debt. Look at the first line. At 90% debt to GDP government stimulus tends to be

less than half as powerful as at low debt levels. We are now more than past 90%. We are over 100% debt / GDP and climbing fast.

Also, when the velocity of money (the rate at which money given to banks multiplies through the economy) is extremely low, as it is now, the effect of government <u>monetary</u> stimulus is much weaker as well. Remember 2009 when Ben Bernanke as his first monetary stimulus (QE 1), printed $2 trillion dollars and gave the banks? Much of thait went to their overseas affiliates, not here. And, much of it went into stock market speculation. How much did the economy grow with $2 trillion in monetary stimulus? – not much, especially compared to what is normal coming out of recession.

The other half of the fiscal cliff fear is that higher taxes, if only from the repeal of the Bush tax cuts, would hurt consumer spending. On this, they are no doubt correct. But, a consensus is building in Washington that they need to work out a deal to keep the Bush tax cuts for everyone earning less than $250,000 – roughly 97% of American families. I don't the fiscal cliff will turn out to be a cliff after all.

<u>Is It Dangerous to Cut Government Spending Now?</u>



Many are afraid that if we truly start cutting government in order to reduce the deficit we will start along the path that Greece has taken. Recall that the Greeks have been forced by their European creditors to put in place austerity measures to cut their national deficit. This is widely blamed for the Greek economy contracting 20% since 2009 with worsening unemployment and shrinking businesses.

Well, sometimes the obvious is not obvious. The Greek problem is *not* that reducing deficits is bad, but that years of a high level of government spending, especially when much of it is borrowed money, leads to painful consequences. It's like focusing on the high cost and very real difficulties of chemotherapy while ignoring and even encouraging the smoking that gave one cancer in the first place.

Greece is the extreme example of the government dominating the economy and sucking resources from the productive economy. While we can argue about what it is, there is an optimal size for government and Greece is way past any reasonable measure of what that might be.

Secondly, Greece has a currency (the Euro) that does not float according to the state of the Greek economy, but according to the European economy, which is far different. So, the Greek currency is not devalued as it ought to be and there is no inflation to reduce the real value of Greek debt.

Third, the Greeks are not competitive in world markets because of unbelievable bureaucracy and red tape and over-the-top restrictions on both businesses and labor. These are the most important things that must be unwound but little effort has been spent on them.

<u>Bottom line</u>: the U.S. is already on the Greek path because of its rapidly increasing debt that is now larger than our economy, because of a pervasive attitude that what we need is more government help,

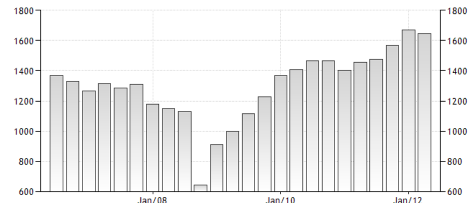
more government spending, higher taxes, more regulation. The end game is on display “across the pond” and yet, we still want to be more like Europe. While it helps that U.S. Treasury interest rates are extremely low, how low they stay there is a function of faith in the US repayment of debt. That is inversely related to the amount of debt we have and that amount is rapidly escalating with no end in sight. Somewhere there is a tipping point and then all available choices will be very painful and difficult.

That’s a few years away. Let’s look at investment strategy for the near term.

<u>Stocks</u>

The U.S. and European stock markets are in a downtrend recently. The downtrend started before the election and while many on Wall St. are disappointed in an Obama victory, *I don’t think the election has much to do with the current decline in stocks.*

The decline has more to do with declining corporate profits as seen in the far right bar at right. (As with all charts in this newsletter, just click to enlarge). It’s just one quarter, but I wonder if the cost-cutting since 2009 has largely run its course.



The chart below shows corporate revenue growth (red bars) compared to forecasts (blue bars). The most recent quarter is second from the right and you can barely see that corporate revenues actually shrank a little last quarter, the fifth straight quarter of growing less quickly than the previous quarter. Since forecasts were much too optimistic the last two quarters, the market is adjusting downward.

As an example, McDonalds, the epitome of a consistently expanding company, yesterday reported its first decline in sales in almost 30 years.

How much of a haircut stock prices deserve is not easy to pin down but for stock prices to decline in the 4Q is fairly unusual, once you get past October.

Looking back at stock market declines over the last four years, we have had three previous declines – 10% in 2010, 15% in 2011 and 7% earlier this year. As of yesterday, we had dropped 6% on this latest decline so unless this one is worse than the others we have probably seen almost half or more of the decline already.

An agreement on the fiscal cliff would probably stop this decline and I expect that to come fairly soon, maybe in the next couple weeks so it is done before Thanksgiving. It has to come before the holiday recess, typically in early to mid December.

Emerging Market Stocks

China is waking up again after a very poor last year. Other emerging markets have declined as well and are fairly attractively priced now, especially when you remember that for the most part, they don't have big banking issues or highly indebted governments. Over the last three months, emerging market funds have handily outperformed our stock market and Europe as a whole.

Bonds

In the short term, I continue to recommend bonds, especially overseas bonds and especially emerging market bonds.

Commodities

I never recommend commodity futures but I do at times buy exchange-traded funds (ETFs) that roughly mirror price changes in the commodity. Oil has fallen enough to warrant consideration and natural gas is probably at or close to a buying point again.

Gold has not acted very well in much of 2012 but I still like it long-term. I have never like buying gold mining stocks and except for brief periods that has served me well. Silver is too volatile for no higher return than gold.

In the investment implications of where we are headed is that stocks need to be those that still do well in slow growth, that income is increasingly important, gold as an inflation hedge is prudent and that the developing world deserves a greater allocation. Of these, only income seems to be popular now.

Alternatives

The vast majority of alternative funds have had terrible returns but I do recommend a very short list of alternative funds as diversifiers. REITs and investments in timber and farmland are at historically high prices and I would be careful there. Don't rely too much on recent performance.

Tax Strategy

I covered this in last month's issue. In taxable accounts, you should think about taking capital gains this year, since those rates are very likely to go up in 2013. The tax rate on dividends is scheduled to lose low tax status and be taxed as ordinary income, so rearrange your portfolio so your dividend-paying

investments are in your tax-deferred accounts. Unless a deal is worked out, the amount excluded from estate tax is dropping from $5 million to $1 million so you may need to change your estate plan once the smoke clears.

401(k)

I may have a special issue coming up that is devoted to problems in 401(k)s, especially for those of you who are senior executives or business owners of companies providing a 401(k) for employees.

If you are in that category, two words ought to really scare you – *personal liability*. If you are a fiduciary, and the sponsoring company always has one or more, you have personal liability with respect to the plan and how it is run. Hint: your fiduciary is a senior decision maker and probably not your HR person.

Better talk to me about it, because what others have been told you, if anything, about how to mitigate that liability is much more complicated than you think and there is no way around your participation.

I do a free audit of fiduciary risk, so let's get going on it.

Dave Hoshour
Cornerstone Investment Services
A Fee-Only Investment Manager
3003 Thorndale Rd.
Indian Trail, NC 28079
704-698-1040 phone
888-320-4495 fax
800-566-2721 toll-free
DaveH@CornerstoneInvestment.com
www.CornerstoneInvestment.com