Real life needs active management

NOVEMBER 30, 2012. ISSUE 11

E.Q Trendwatch™

Two are one

"No people were ever honored for what they received. Honor has been the reward for what they gave." --Calvin Coolidge 1872-1933, 30th US President

In January 1914, car baron Henry Ford startled the world by announcing that Ford Motor Company was doubling its 'average workers' pay to $5 a day while shortening the work day to 8 hours from the then standard 9. Papers around the world heralded this as an extraordinary act of goodwill and the news attracted thousands of motivated workers towards Detroit from all over America and Europe.

In reality the changes were not purely selfless. They were aimed at helping Ford's employees **and** his business. First, he sought to reduce employee turnover in the monotonous work of shifts on his newly invented manufacturing lines. And he was successful—employee turnover diminished, and with an eight-hour day, Ford could run three shifts instead of two—significantly increasing productivity.

His second motivation was a longer-term vision. Ford reasoned that since he could now build inexpensive cars in volume, more of them could be sold if employees

Cory Venable CIM, FCSI, CMT
Technical Market Analyst

Danielle Park LL.B., CFP, CFA
Portfolio Manager

Venable Park Investment Counsel Inc.

Venable Park Investment Counsel Inc.
www.venablepark.com

33 Clapperton St.
Barrie ON L4M 3E6
Tel: (705) 792-3991
Toll Free: 866-792-3991
Fax: (705) 792-3992

could afford to buy them. In this thinking, Ford became a role model and beacon to other business leaders in his willingness to 'share the wealth' in order to promote greater prosperity among the working class. While more costly in the short-run, the idea ended up increasing company profits in the longer run by helping to create a larger pool of potential consumers. It also marked a significant departure from the classist ideals of feudal Europe and aided the emergence of a growing middle class that the free world built on over the next 85 years.

Those resisting responsible fiscal reforms today could take a page from Henry Ford

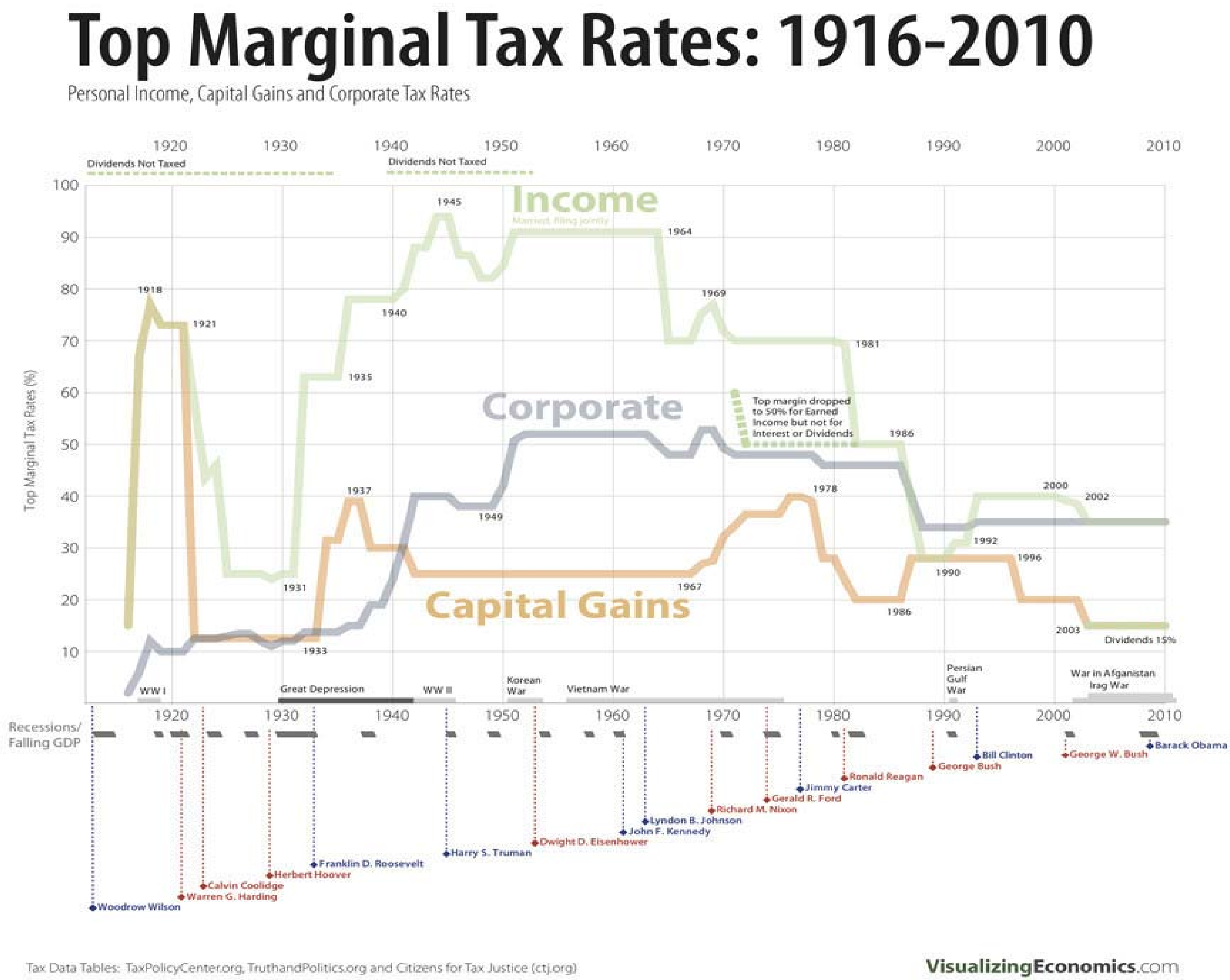
The more prosperous nations become, the more that is expected. Since 1980, the culture of collaboration between business and labor has been in a state of gradual decline. Falling interest rates, credit complacency and bubbling asset prices, all seemed to afford more for workers without actual pay increases. Collective responsibility and cooperation gave way to an era of individual rights and entitlements. People began to think of businesses less as a long-term store of wealth for owners and workers and more as a vehicle for short-term profits, bonus and leverage. As outside investors in public companies became more prevalent, management grew more focused on placating them through escalating dividends and share buy-backs rather than allocating capital to strategic investment in equipment, infrastructure, innovation and training. Tax policy and compensation structures increasingly incented executives to sacrifice corporate balance sheets in order to pump up the income statement. Particularly in America, executive compensation soared to a record 300x+ the average worker's pay in the US (some 200x in Canada).

Similar extractive ideas blossomed in governments as year after year deficits rose and debt mounted in order to afford ever greater short-term spending and subsidies for special interest groups. At the same time, as the Boomers aged, in America funding to public education was steadily cut from more than 35% of government expenditures in 1980 to just 25% today. A "have now, pay later' mentality became pervasive in households, business and governments alike. Then suddenly, the numbers grew much worse.

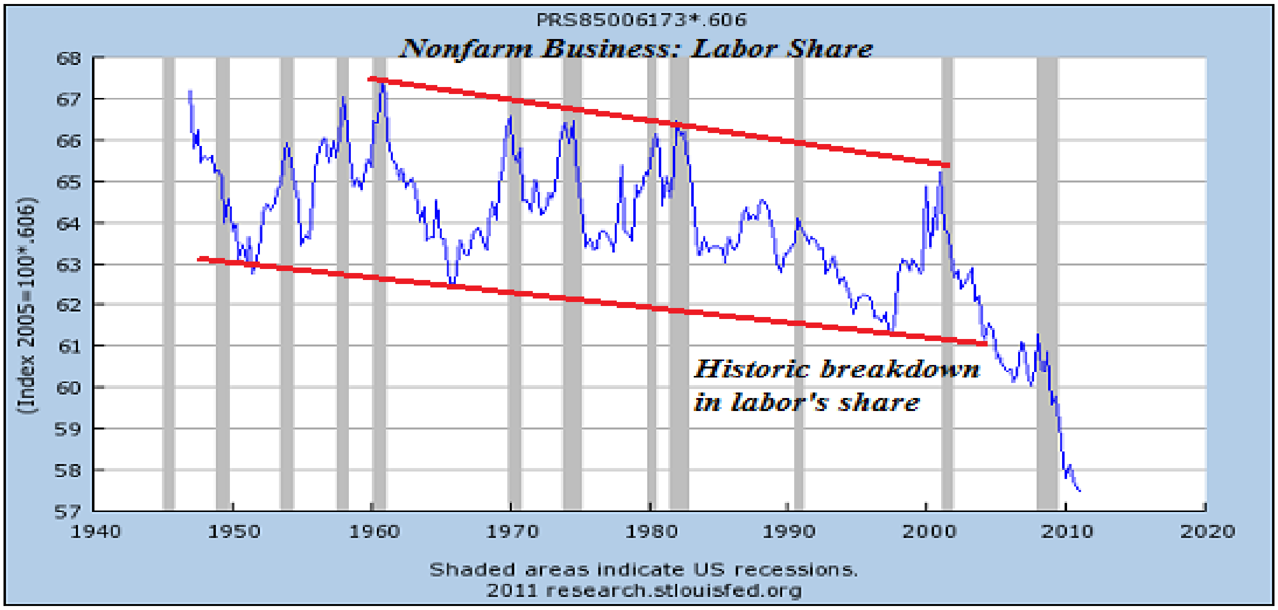
Following 9/11, the American Congress committed to funding two foreign wars in Afghanistan and then Iraq without cutting spending in other areas but while rolling out a series of time-limited tax cuts cited as necessary to revive the private sector from the 2001-02 recession.

These programs became known as the "Bush tax cuts" and specifically were implemented via the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). The Bush tax cuts as originally agreed had sunset provisions that made them expire at the end of 2010. When this deadline approached, however, whether to renew the lowered rates and how became the subject of extended political gridlock wherein the Democrats proposed an extension for only those earning less than $250,000 and the Republicans refused to agree to a rate increase for those earning more than $250,000. This stalemate resulted in a further two-year extension of lowered tax collection that was part of a larger tax and economic package, dubbed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

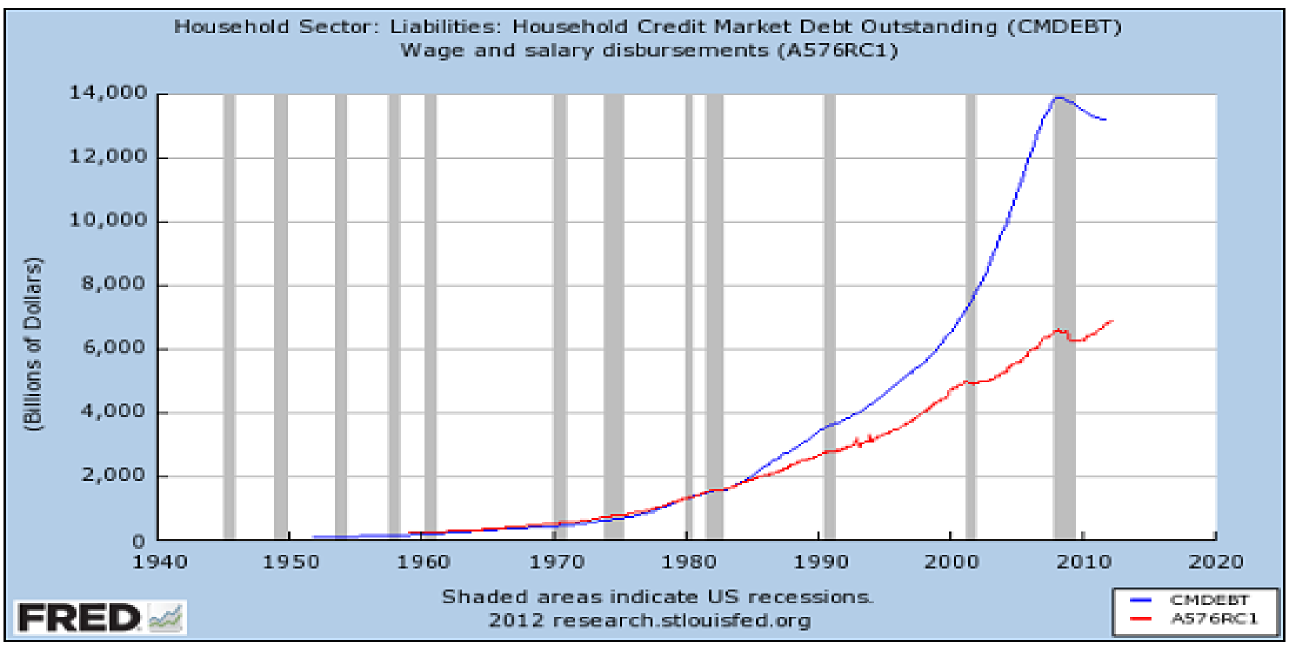
As a result of all of this, tax rates in America relentlessly declined from a top tax rate of 70% in the early 80's (it had been 91% in 1945 and 88% until 1963) down to a low of 35% over the past 10 years. Over the same time frame capital gains and dividend tax rates were slashed from 40% in 1980 down to 15% with the Bush cuts. The effect has been to afford large tax savings to those who have excess capital over workers who have only their labor to support them. It also means that the wealthiest people in America are now paying the lowest average tax rates seen in more than five decades at about 25%, all while government spending has continued to mount.



Unlike the prosperity gains made by workers in the first half of the 20th century, over the past 13 years labor's share of business revenue has now plummeted to the lowest levels on record (shown here).



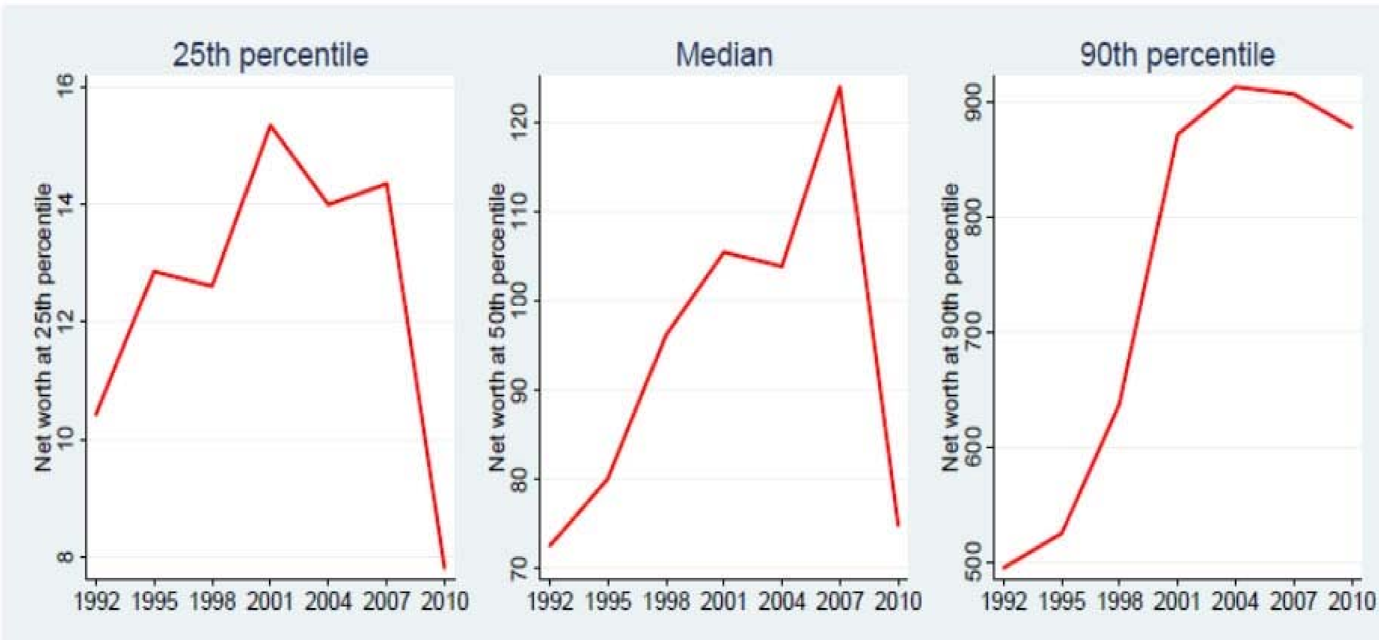
To fund spending deficits, the masses turned to credit (blue below) and governments issued debt.



Milked dry, the cow must now be fed

Results have been predictable. The top 10% of the population have made significant wealth gains over the past 20 years while the other 90% have made no progress and the lowest quarter of the populations has less net worth today than in 1992.

Net Wealth Shock in the USA *Source:* https://twitter.com/profsufi



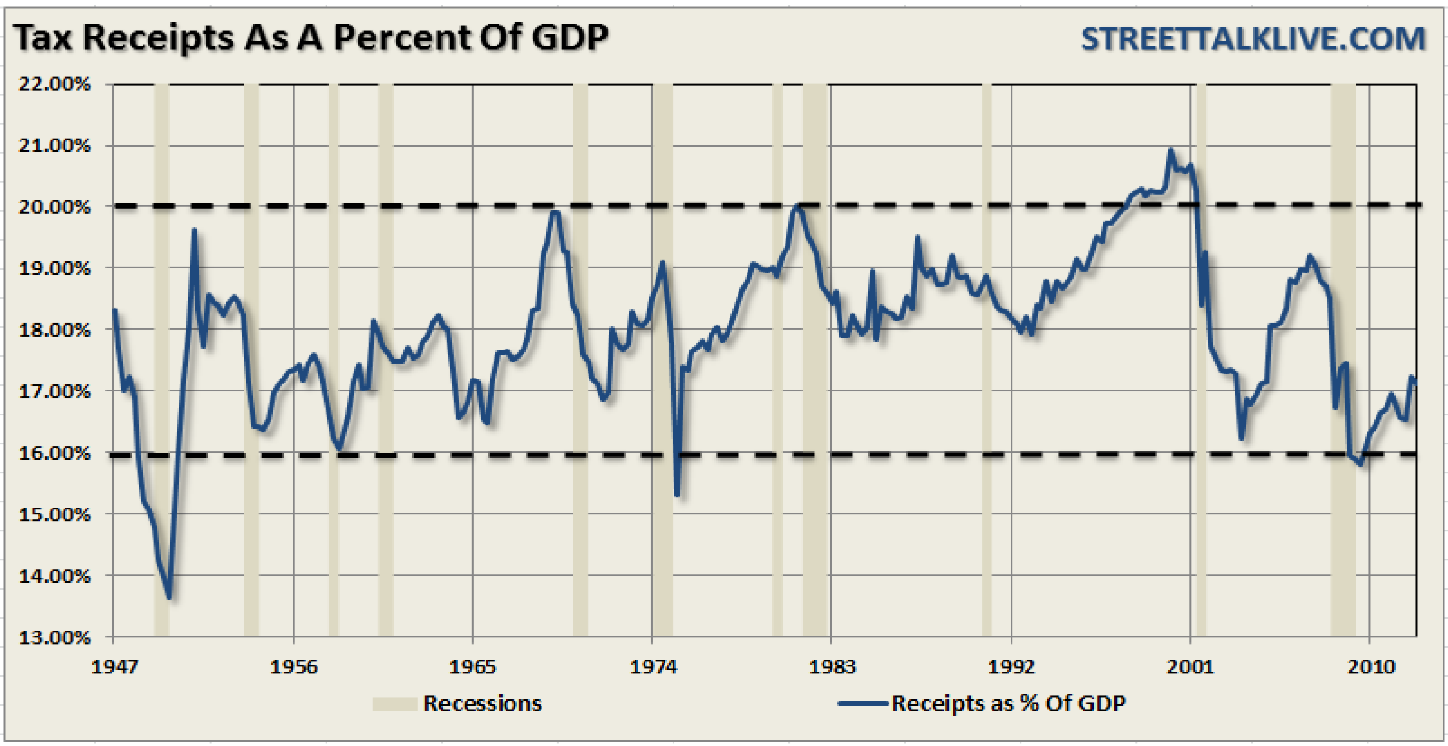
Now that interest rates are already at 100 year lows and consumer debts around the world are already at historic highs, the likelihood of spurring another credit-fuelled asset bubble by reflating balance sheets is low. This means that a new playbook is needed. Equity in households and nations will now need to be rebuilt the old-fashioned way through hard work, discipline, shared sacrifice, and giving more in the short run in order to rebuild fiscal health in the longer run.

This will require several years of selective government spending and higher revenue collection from those who have capital—both labour and savings. It will also require increased investment in training and education. While unemployment has increased in most of the developed world since 2008, 40% of American small businesses today say that they cannot find workers with the skills required to fill their job openings. There is great opportunity here for those who are able to position for it.

The truth is that the fiscal cliff already happened

So while much hyperbole has been uttered of late warning that the slated expiration of the Bush era tax cuts and reduced government spending in 2013 will prove fiscally fatal for America and the already weak global economy, the truth is that the 'fiscal cliff' already happened over the past 12 years.

Those who argue that the resumption of higher tax rates will necessarily be disastrous and anti-growth are also ignoring the reality that most developed countries including Canada have been paying tax rates at or above the US rates slated to resume in 2013. The US itself was collecting similar and even much higher rates during its longest and most prosperous economic expansion in history from 1982 to 1999. As shown in the next chart, tax receipts as a percent of US GDP are today at historically low levels. While this might be reasonable if government coffers were high and households flush, it is simply not prudent when the nation is weakened from more than a decade of over-spending and under-investment.



For most it will never seem like a good time to cut spending and restore responsible tax collection. But the reality is that rebuilding presently dilapidated balance sheets requires policies that will do both. Putting real numbers into perspective, as shown in the chart below, allowing the Bush tax cuts to expire as planned will result in income tax increases, most of all for the wealthiest— but the dollars cannot be considered catastrophic to disposable income at any level.

AVERAGE TAX INCREASES AT DIFFERENT INCOME LEVELS	Tax increase
Lowest 20% ($20,113 or less)	$412
Low-middle 20% ($20,114 - $39,790)	$1,231
Middle 20% ($39,791 - $64,484)	$1,984
Upper-middle 20% ($64,485 - $108,266)	$3,540
Highest 20% ($108,267 and above)	$14,173
Top 1% ($506,210 and above)	$120,537

Source: Tax Policy Center

It is also critical to note that as itemized below, the cash flow improvement of the 'fiscal cliff' would total just $671 billion in 2013. Still relatively mild progress, when compared with the $1 trillion per year that the US is presently spending above its income, and the 16 trillion dollars of debt already weighing on the nation's cash flow. In other words, even with the "cliff" the US will still be adding some $330 billion to debt in 2013 (likely more as the global slowdown subtracts more revenue than presently expected.) And if they extend the tax cuts for those making less than $250K as both parties seem to want, the deficit will add more like $600 billion to the debt in 2013 alone.

FISCAL CLIFF TAX INCREASES	Amount in Billions
Higher taxes on income below $250,000, higher estate taxes, alternative minimum tax.	$279
Higher taxes on income above $250,000.	$52
Expiration of Social Security tax cut.	$115
Expiration of temporary tax breaks for businesses and individuals.	$110
Expiration of extended unemployment benefits.	$30
Defense spending cuts.	$32
Across-the-board cuts to education, health, law enforcement, other programs.	$53
Total	**$671**

Source: CBO, Tax Policy Center

With 10,000 boomers turning 65 every day in America now, the budget fight at hand is not really between the left and the right, but between the old and the young.

Total US federal liabilities, including unfunded promises for Medicare and Social Security, and other commitments actually amount to some $71 trillion today (growing at about 100 billion a week.) **There is simply no way for income to keep up with these costs while maintaining the investment needed for a civilized and progressive society.** Numbers are similarly untenable in a host of other countries dealing with disproportionately aging populations. Adult diapers sales in Japan today are greater than for infants!

Boomers on both sides want their tax savings and all of their social benefits too. Meanwhile this is a generation who have eaten their cake for years now, indulging their wants while setting aside very little for the future. Their expectations are simply thwarting the financial viability of the developed world. Large entitlement cuts must be part of viable fiscal solutions. It is time for adults to admit and reform.

Relief and optimism may well prompt stock market gyrations on news of fiscal 'deals' out of Washington.

However only serious reforms, rather than can kicking, will have a lasting effect. And no matter what governments negotiate at this point— higher taxes and budget cuts or just a continuation of runaway deficits—all will lead to slower global growth in 2013.

Clearly, the future does not belong to the dominance of labour over business, or left over right; but somewhere in a mediated middle. As Henry Ford understood, when it comes to the collective interests of national prosperity, different sides are actually not separate but one. The young need the old and the old need the young. Businesses need qualified workers and workers need sustainable businesses. And everyone needs customers who can afford to buy goods and services.

In the end, North America remains ideally situated with enormous advantage in rich geography and natural resources, stable democracy, evolved legal systems, strong reproductive and immigration rates and still relatively better educated and emancipated citizens than any other continent in the world.

A serious path to fiscal recovery will involve the concentrated focus of business and governments on increased energy-efficiency and development of domestic energy sources of all kinds. This will prove a lasting investment that will create valuable jobs. It will also plug a critical hole in a negative US cash flow that is presently wasting $400 billion a year (40% of the national deficit) on buying foreign oil. By present policies, energy self-sufficiency for America is estimated to be attainable within 10 years. A hyper focus on this today can accelerate that goal by years. Yes, taxes must go up and spending must go down. But there is great strength to be developed here and serious steps in this regard will offer something to be truly bullish about.

"We are the ones we've been waiting for."—Hopi elder

In the charts: Stocks continue to ignore economic growth prospects

This month the Economic Cycle Research Institute (ECRI) reaffirmed its call that a US recession began in July of 2012. As shown in the chart below, US macro-economic indicators (red below) have been declining now since the business cycle peak in the fall of 2010. Typically US stocks have served as a leading indicator of economic growth. The S&P 500 (green below) did in fact acknowledge the economic downturn in 2010 and entered a meaningful correction through the first quarter of 2011. It was at that time that the US Fed announced another attempt at Quantitative Easing and the S&P 500 surged on the news. Since then US stocks have traded in a world of their own, decoupling from US macro trends. The gap (in the chart below) between US equity prices and US growth has warned of significant capital risk ever since. As the ECRI index continues to contract, and with the Federal Reserve now out of bullets, the S&P risks recoupling with the downturn in earnest.

S&P 500 (red) versus the ECRI US macro growth trend (green) 2007 to 2012

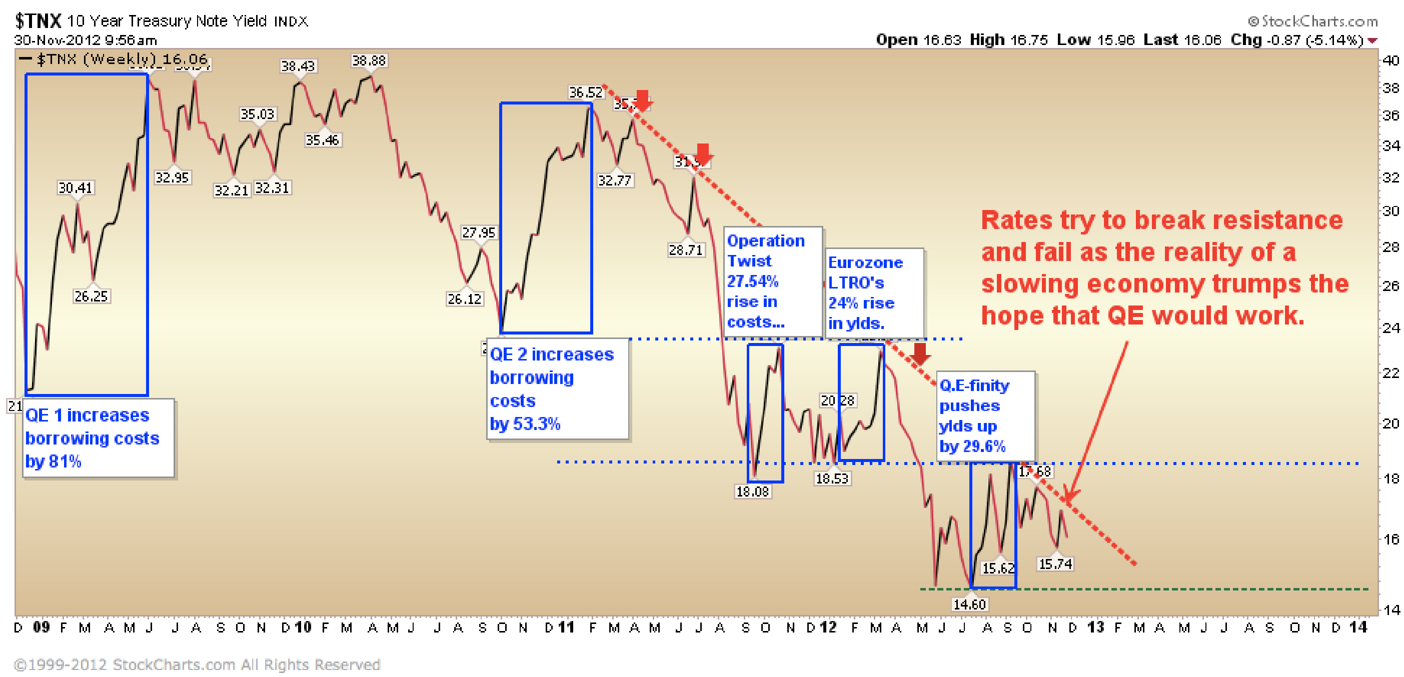
Other risk markets such as commodities, junior resource companies, Chinese and Canadian stocks have not enjoyed the same bounce and have continued to weaken in sympathy with the slowing global economy. This month the Chinese Shanghai composite broke below the 2000 level to close within 15% of the cycle low it reached at the beginning of the 2008 global recession. We had been expecting this decline and now wait to see how other stock and commodity markets may follow this leadership.

Chinese stock market continues to beckon world markets lower in November

Canadian TSX continues to slump in sympathy with falling commodity demand- Mark Carney bows out

The $US continues to attract international inflows as fiscal haggling suggests austerity —$88 upside target

Bonds continue to see inflows: 10-year US Treasury yields confirm economic downturn in November



November ends with the distraction of the US election finally concluded and political leaders forced back to the negotiating table with most of the same players and issues—once more mired in difficult debt and deficit negotiations. There is no telling whether an interim stopgap agreement may be reached before the Christmas break. But regardless, slowing global growth seems likely to reassert itself as the central focus of financial markets in the first quarter of 2013. We believe that the weight of the global recession will eventually weigh heavy on asset prices that have, since 2010, significantly overshot reasonable earnings and revenue expectations. We see no reason to doubt that bonds, cash and the US dollar will continue to offer the best harbour in this storm while risk assets re-price some more.

A very merry December to you and yours!

Quotes of the month:

"Wealth is not created by artificially cheapening money. When prices are manipulated to the point where they have nothing to do with reality, then the only rational decision is to shift to cash and wait for prices to send signals again. As a result, the velocity of money goes to zero and the economy moves ex-growth. This is exactly what we are seeing today as the world's idiotic central banks apply a strategy that Japan has spent 20 years proving does not work." –Charles Gave, GK Research, November 2, 2012

"Does anyone stop to consider that the two largest contributors to the IMF are the two largest debtor nations in the world? Are things beginning to make sense now?"—Kyle Bass, Hayman Capital, Nov 15, 2012

"I guess I'm old fashioned, but I continue to find it astonishing that the Bernanke Federal Reserve believes it is within its mandate to incite risk-taking from our savers."—Doug Noland, Safe Haven, November 2012

"The ultimate result of shielding people from the effects of their folly is to fill the world with fools."

—Herbert Spencer, English philosopher (1820-1903)

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