HOWE & RUSLING

INVESTMENT STRATEGY NEWS

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Short Term Gains, Longer Term Pains?

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AT A GLANCE

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The stock market quietly enjoyed good performance in the first quarter of the new decade while the politics domestically were anything but quiet as the health care debate raged. I know many of you are tired of hearing or reading about health care, but it is tough to ignore the passage of the bill when writing an article about the quarter. We will address the new law later in the article because it increases our concerns about the looming drags on economic growth—increasing government debt and increasing taxes.

The improvement in the economy has continued from 2009 with retail sales better than expected, improving consumer confidence and increasing industrial production. The improvement in the economy and the productivity gains enjoyed by companies has led to strong earnings and increasing stock prices. The consensus of economists is that the economy will grow upwards of 4% in 2010. We believe that much of this anticipated good economic news is already reflected in stock prices. Coming off a very strong year for the S&P 500 and a better year for H&R stocks in client portfolios, we believe stock valuations are much closer to fair value. Coming off the very strong year last year for the S&P and H&R stocks, we have been slightly more defensive in 2010 both in allocation to stocks and in type of stocks that we are buying choosing to stick with quality and emphasizing defensive characteristics.

We are also skeptical that economic growth will be as strong as the consensus. While the economy has improved and will grow, it has improved with two important exceptions: employment and housing. Not much has improved in the unemployment figures and not much has improved in new housing starts or housing prices both of which are important to strong economic growth. The unemployment rate sits stubbornly at 9.7% and it is difficult to envision a sustained recovery without strengthening employment.

We are not banging the table about a double dip recession; we are simply concerned that growth will not be as strong as forecast which will make the year a little tougher than anticipated for stock prices. If we are wrong and the market continues to move dramatically higher, we will be making good returns for our clients just maybe not as much as if we rolled the dice on lesser quality stocks.

Of Debt and Taxes

In the longer term, we are concerned about the skyrocketing debt, and the seemingly unquenchable desire by the federal and state governments to continue spending. The combination of remedies—increasing interest rates and inflation and increasing taxes rather than a reduction in spending do not seem to us a scenario that ends all that well for a fragile economy.

It is common wisdom that the Bush tax cuts will be allowed to expire at the end of 2010 which will drive tax rates higher for those with taxable income above $28,400 up to a maximum rate of 39.6% for the highest wage earners. Additionally, capital gains tax rates will increase from 15% to 20%. (In a weird aside, in 2010 there is no estate tax. It is commonly thought that Congress will reduce the exemption from "unlimited" to $3.5mm or so and apply it retroactively to the beginning of the year. If left unchanged, the exemption reverts back to $1mm with a maximum tax rate of 55% in 2011).

The President appointed a Deficit Reduction Commission to offer suggestions to Congress on reducing the deficit. We are not hopeful that this is anything other than a way for Congress and the Administration to attempt to duck their responsibility and have somebody else to blame when a national sales tax or a European style Value Added Tax is proposed. This quote from the Washington Post, "Some Democratic appointees [to the Commission], including Andrew Stern, president of the Service Employees International Union, have signaled their intention to protect entitlement spending, which would require higher taxes." Enough said.

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Healthcare

The final reconciliation of the health bill was signed into law on March 30th. The rhetoric of supporters and detractors of the health care bill continues to be much hotter than the immediate impact of the bill. The world did not end for investors or otherwise, and, nor for that matter, did all US citizens suddenly enjoy universal health coverage.

Most of the provisions in the bill that impact individuals begin after the Presidential election in 2012. Our favorite quote in support of the bill was from a citizen without current health coverage that said "it's going to be like Christmas" now that everyone is covered.

Even though everyone is definitely not covered yet (more on that later), the stock market has shrugged off the future impact of the bill and continued its steady march upward, focused as it is on expected nearer term earnings and economic activity. When we take a look at the longer-term with the massive deficit and then the spending and taxes to maintain a program like the new health-care mandate, we are concerned that there will be more drags on future growth.

We are not sure many in Congress completely understood what was in the bill. Our view was reinforced when several large companies like AT&T, Caterpillar and Verizon to name a few were forced to take a charge against earnings immediately as required by the SEC because they will be losing the benefit of a tax deduction in 2013 to the apparent shock of many in Congress.

Immediate Impact

There is very little immediate impact. The tax subsidy for companies that offer Medicare Part D retiree drug subsidy payments will be eliminated in 2013. However, the immediate impact is that many companies are preparing for the increase in costs by taking a charge now. A high-risk pool to provide health coverage to individuals with pre-existing medical conditions will be established and health insurers will not be able to exclude pre-existing conditions for children. Other than the charge taken by AT&T and other large companies, the only tax impact initially will be a 10% tax on indoor tanning services. Finally, there are some tax credits for small businesses that begin this year if the business has 10 or fewer employees and the employees average less than $25,000 in annual wages or $50,000 if there are more than 10 but fewer than 25 employees.

Longer Term Impact

The scoring (estimation of the cost of the bill) the bill received by the CBO was clever politically, but the costs will be more painful in reality because the costs and the expansion of coverage does not really kick in until 2014. The bill was scored to cost under $1 trillion for the first ten years, but included only six years of estimated costs (and actually excluded the "doctor fix" costs of an estimated $200 billion.) It would have been a much more useful exercise to estimate costs from 2014-2024. Increasing the number of people eligible for Medicaid (federal government payments to states fall from 100% in 2014 to 90% by 2020), offering premium credits for individuals depending on income and establishing insurance exchanges all begin in 2014.

The taxes start sooner than the benefits:

The Medicare Part A tax rate will increase on wages by 0.9% (from 1.45% to 2.35%) on earnings over $200,000/individuals and $250,000/jointly and a 3.8% tax on unearned income (such as capital gains) for those same tax payers (effectively moving the capital gains tax rate for higher earners to 23.8%.) The amount individuals are able to contribute to a health savings account is reduced to $2,500 per year. Individuals without health coverage will be fined the greater of $95 or 1.0% of taxable income in 2014 increasing to the greater of $695 or 2.5% of taxable income in 2016. The law changes subsidies (effectively cuts) to Medicare Advantage plans starting in 2011 decreasing benefits and placing more limits on care.

On the business side, pharmaceutical companies will start paying additional taxes of a combined $2.8 billion in 2012, rising to $4.1 billion in 2018 and then falling again to $2.8 billion in 2019. Medical device companies will pay an excise tax of 2.3% on the sale of any device. Health insurers will begin paying an additional tax of a combined $8 billion in 2014 rising to $14.3 billion in 2018. Like health insurers, it is uncertain how hospitals will be impacted. On the one hand, insurance will be paying for millions more citizens, but on the other hand there are not insignificant cuts to annual increases to Medicare reimbursement rates.

There are many more provisions and these are just a few of the highlights. From a purely investment standpoint, we are concerned the law will cost a lot more than advertised increasing a debt that is already spiraling out of control increasing the pressure to raise taxes in addition to the increase in taxes coming at the end of this year.

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We do not mean to be purveyors of doom. The US economy is still the largest and most important in the world and continuing to expand. Politics tends to be a pendulum and we are hopeful that the pendulum will swing away from spending and back toward fiscal responsibility regardless of which party is in power. After the spectacular gains of 2009 have gotten many stock prices much closer to fair value and given the current fiscal issues in the US, we have chosen to be slightly more defensive, choosing to buy or own stocks that have a higher quality than some of the stocks that have outperformed in 2010. Too many questions, we think, to simply roll the dice in terms of allocation and aggressive stocks. We always reserve the right to adjust if it turns out that we are too early in positioning the portfolios with too much care. For now we are comfortable. We remain invested and we are not betting on a double dip; we simply have concerns about where this is all headed.

1st Quarter – Bond Market Overview

The bond market continues its string of positive quarterly performances. Of the major sectors that we monitor, corporate bonds continue to outperform government bonds. Our clients' bond holdings have produced another period of nicely positive returns, despite pervasive inflationary fears. Inflation statistics released by the Department of Labor of late have been benign.

As we have mentioned in previous newsletters, while the supply of money has increased dramatically since the financial crisis hit in the fall of 2008, the amount of money that is actually being lent out by banks is not leading to increasing prices. The last 3 months of CPI readings for core inflation (without food or energy) have been: 0.1%, -0.1%, and 0.1% or 0.4% annualized. The overall CPI readings for inflation (including food and energy) have been 0.2%, 0.2%, and 0.0% or 1.6% annualized. Both measures are well below the unofficial inflation target of 2.0% annually.

The new global credit market worry that has been getting a lot of press is "Sovereign" debt, and particularly the debt burden of Greece. Is the Greek economy of such great global importance to warrant such worry? The answer is, with all due respect to the sovereign nation of Greece, "probably not." We're not going to expand on the fiscal problems of Greece in this writing; the issue is bigger than Greece alone. The situation in Greece, and its impact on the Euro currency, may just be the proverbial "canary in the mine."

What is Sovereign debt? Quite simply, Sovereign debt is the sum of all debt obligations guaranteed by a government. Increasingly, the capital markets are turning their focus on each nation's ability to service its respective debt obligations (make regular payments of interest and principal). However, this is not a new concern, but rather one that resurfaces during severe economic downturns, i.e., recessions. It is only natural that the concerns surrounding the servicing of sovereign debt are heightened during recessionary periods because of decreased revenues from taxes. Furthermore, a government's inability or unwillingness to decrease discretionary expenditures could exacerbate the perceived credit risk of a sovereign default and create a great deal of uncertainty for creditors and debtors. Uncertainty is by no means anything new for the capital markets. However, it does not usually apply to the "safest" capital investment that one can make – Government bonds or the Sovereign bonds of highly rated foreign governments.

Of course not all sovereign bonds share the same credit risk. In a March 2009 study[1] issued by Moody's Investors Service, as of 2008 only 18% of all sovereign issuers in the study had the highest credit rating of AAA. In the study, 61% of the sovereign issuers were rated investment grade while the remaining 39% were below investment grade. And of course, defaults do occur. The two biggest sovereign defaults during the same period studied by Moody's were Russia (1998 - $72.7 billion) and Argentina (2001 - $82.3 billion). For comparative purposes, Greece's total debt outstanding at the end of 2009 was approximately $400 billion according to its own finance ministry.[2] While this amount may seem to be a great deal more than the Russian and Argentine amounts mentioned, those were not adjusted for inflation. Also, relative to what our own U.S. Government spends, $400 billion is significantly less than the U.S. budget deficit for the first five months of this fiscal year. On March 10 the Treasury Department reported that the February deficit totaled $220.9 billion and $651.6 billion in the first five months. So, it's not just Greece, it's also Portugal, Spain, Ireland, the U.K., Japan and just maybe, the U.S.

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We all know now that the chosen solution to address the financial crisis of 2008 was for central banks and governments, globally, to "re-liquify" the banking system and soften the shock of collapsing demand through easy monetary and fiscal policies. While the actions taken were deemed necessary to prevent greater destruction of economic wealth and well being, the capital markets may be sending a "signal" that it's time to address the longer-term structural problems inherent with overspending and excessive borrowing by governments around the world. This "signal" should not be disregarded and has been echoed by Moody's in a statement issued on March 15. They warned that Western governments that currently enjoy the highest of credit ratings have moved "substantially" closer to losing that edge. The ratings are "stable," but "their 'distance-to-downgrade' has in all cases substantially diminished." They also commented on the social impact of these nations' debt burdens.

"Growth alone will not resolve an increasingly complicated debt equation. Preserving debt affordability at levels consistent with Aaa ratings will invariably require fiscal adjustments of a magnitude that, in some cases, will test social cohesion."[3]

It should not be surprising to anyone that such divisiveness will continue, as governments begin to seriously confront the fiscal realities of these debt burdens. As it relates to our own economy in the United States of America, the fiscal realities require reducing expenditures and raising taxes at all levels of government. Regardless of political ideology, there is no "magic" solution to our structural problems. While there may be different approaches to addressing our nation's fiscal imbalances, the end result is that we will all feel the negative effects of our unsustainable obligations.

Howe and Rusling's approach to fixed income investing is characterized by a prudent risk management discipline. Our objective is to anticipate changes to the risk/reward attributes of our clients' fixed income portfolios. Our focus prior to the 2008 financial crisis was on maintaining a high credit quality strategy along with assuming moderate interest rate risk. With the capital markets showing signs of stabilization in the first quarter of 2009 we recognized an opportunity to increase our credit exposure to corporate bonds while maintaining high credit quality. The challenge facing us now is anticipating the effects of future monetary and fiscal policies. Having addressed the current capital market concerns regarding sovereign debt, we don't believe we are facing any realistic threat of a major sovereign nation being downgraded. However, we do believe that the warnings are real and will be taken seriously. While we do expect fiscal policy will have to change, unfortunately, we cannot predict the timing. We've already begun to see state and local governments addressing their fiscal imbalances and would expect more measures taken as the Federal funds supporting mandated programs may not be available in the coming years.

Monetary policy changes will most likely precede fiscal policy changes, simply because the Federal Reserve has the discretion and independence (for now) to act more promptly than does congress. We are already seeing the termination of emergency liquidity programs and quantitative easing programs instituted by the central bank. The actual increasing of short-term interest rates (Fed funds) will be dependent on economic conditions as they develop. It is highly unlikely that the Federal Reserve will increase the Fed funds rate without improvement in the labor market and without a marked increased in expectations for inflation. We need to be vigilant on the capital market's reaction to the reduction of the quantitative easing efforts of the central bank. We are cognizant of the possibility that our fragile economic recovery could be compromised by removal of the accommodative monetary policy that is currently in place. Do we see an upcoming "double-dip" recession? It is too early to tell. However, it is more likely that our economy will have significantly lower growth prospects because of our structural debt problems and the ineffectiveness of monetary policy to overcome this burden. These are challenging times and we will continue to do our best to manage through the "cloud" of uncertainty.

[1] March 2009 - **Special Comment - Moody's Global Credit Policy - Sovereign Default and Recovery Rates, 1983-2008**

[2] ©2010 Bloomberg L.P. - Feb. 24 (Bloomberg) - **"Harvard's Rogoff Sees Sovereign Defaults, 'Painful' Austerity"** by Aki Ito and Jason Clenfield

[3] March 15, 2010 - **The New York Times- Moody's Says U.S. Debt Could Test Triple-A Rating** by David Jolly and Catherine Rampell