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INVESTMENT POLICY MEMO

There is now no doubt that the U.S. is in the second year of an economic recovery, although most commentators continue to fret about how frail it is and thus likely to expire in its youth. As noted in my last Memo this recovery has been notably normal in every way. Growth has hovered steadily near 3%, which is the average for the first 15 months of previous recoveries. Investment is increasing. Government fiscal policy is enormously stimulative, comparable to past shooting wars and far in excess of the past War on Poverty or New Deal. There are only two unusual things about the recovery so far. First, real disposable personal income is growing much faster than normal, which in turn has allowed consumption to grow fast at the same time that savings has increased dramatically, and atypically. Second, contrary to most of American history since the end of World War II, the evidence indicates that low wage, low skill workers are gaining on their better paid counterparts.

The primary reason the economy is growing at a moderate pace is that the recent recession was also quite moderate. Another reason is that the growth of population and labor force in America has continued to slow to something around 1% or 1.5% a year, augmented to some extent by illegal and uncounted immigration. In this context the 3% growth, which is widely viewed as "moderate" or even as a symptom of economic illness, is in fact close to the maximum rate at which our economy can grow on a sustained basis. Continued growth at this rate would be the best guarantee of a long and healthy economic expansion.

Of course unemployment remains high by the standards of the past fifteen years, and higher than it ought to be or needs to be. Even this is quite consistent with the pattern of past recoveries. Because discouraged workers come back into the labor force when the economy recovers and because employers are anxious to restore profits by making more intense use of existing employees and equipment, even healthy growth of output does not reduce the unemployment rate for the first nine to eighteen months of economic expansion. If this pattern still holds we should begin to see large increases in employment starting this spring.

For the author of this Memo and for most of its readers the issue is not so much the quality of the recovery as the quality of the foreign escapades and domestic policies being launched in Washington.

America apparently is lunging toward war against Iraq. Other than its convenience for the Republican cause in the last election and its utility to American oil interests, it is difficult to understand why this threatened new disaster for the people of Iraq is suddenly urgent. Like Senator McCarthy with his never unveiled list of Communists in the State Department, the President's men claim to have certain knowledge of the presence of weapons of mass destruction in Iraq and, like Senator McCarthy, they are unwilling to share this information apparently even with the UN weapons inspectors.

However, it is at least possible that all of the Administration's military huffing and puffing is a deliberate bluff intended to win electoral gains at home, political advantages internationally and perhaps a regime change in Iraq (or the disclosure and destruction of any weapons of mass destruction that may exist). That no war has started so far and that international opinion and procedure has been paid at least nominal respect over the past three or four months are facts consistent with this possibility. The stock market rally over the past three months is partly a result of this unexpected American "restraint".

Domestically, the Bush Administration continues to push ahead with its rob the poor to pay the rich agenda. Here there is no bluff. The President's past and proposed tax cuts will unambiguously benefit the rich, especially because of the proposed elimination of the estate tax and reduction of taxes on stock market earnings. However, the past and proposed tax cuts also contain many benefits for the poor and middle class, such as reductions of marginal tax rates, elimination of the "marriage penalty" and increased exemptions for children. In any case the increases in spending -- which have done far more than half the work of converting a \$200 billion surplus into a \$200 billion deficit -- have been consistently beneficial to lower income lower skilled workers as indicated by the wage data and the relatively steep and very unusual declines in unemployment among teenagers and blacks.

Data showing new increases in inequality of income and wealth in the U.S. is all still from the late 1990's. If anyone gets credit for these dismal data it is William Jefferson Clinton, the President who eliminated welfare, brought interest rates to historic lows, gave us our first sustained budget surplus since the 1920's and presided over an even greater stock market boom than did Calvin Coolidge. His successor has put every one of these trends into reverse, including I think the amount of income and wealth inequality. I leave it to the sophists to determine whether Clinton intended to make the poor poorer or Bush intends to make them better off. It is certainly possible that each did and Bush still does intend to do exactly that, in both cases to win perceived political advantages. Clinton trying to appease his long time corporate and Wall Street backers as well as blue collar white men who were defecting to the Republicans. Bush trying to make the Republicans a majority party so that they can continue delivering goodies to their financial backers.

The decline in the stock market is itself the principal cause of a smaller gap between rich and poor in the value of assets owned. The market has fallen for many reasons including its over-exuberant valuations in early 2000, the onset of a recession, and 9/11. It has also fallen as a consequence of Bush Administration policies that increase the deficit, increase demand for low-income workers, and increase the likely level of future interest rates and future inflation. The recession is long over; but these other negatives will continue to weigh on stock prices and cause lower returns than investors earned in the 1980's and 1990's or even in the hundred years before that.

Of all Bush's tax cuts only the proposed changes in the taxation of dividends and certain capital gains might have a direct positive impact on stock prices. The idea is to eliminate the "double taxation" of corporate profits first by the corporate income tax and then through the individual income and capital gains taxes. The proposal is refreshingly simple, elegant, and fair. Its benefits are available only to the extent that a corporation's payment of federal taxes in cash

approaches the statutory corporate income tax rate of 35%. Just about every corporation in America, especially large ones, falls very far short of paying this rate. From those earnings which are deemed to have been fully taxed, a corporation may pay dividends to shareholders which will be exempt from tax or it may reinvest them in the business in which case shareholders will be allowed to add the amount reinvested to their cost basis, thus lowering any ultimate capital gains tax.

The proposal works going forward only. There are no windfalls from past events. So, for example, Bill Gates cannot pay himself his sizeable share of Microsoft's \$40 billion cash hoard as a tax-free dividend. Nor may he add it to his cost basis in the event he sells Microsoft shares. This would be true even if, as is certainly not the case, Microsoft had paid taxes equal to 35% of its profits every year since it was founded.

As far as it goes, the proposal should make shareholders, and theoretically the companies they own, completely neutral between paying dividends and reinvesting in their businesses. The existing law penalizes the payment of dividends, which is an important reason why Microsoft has its \$40 billion stash in the first place. However, to a greater extent than Microsoft, many companies have managements with interests of their own that are not always the same as shareholders. Moreover, more than 60% of all U.S. stocks are owned by retirement plans, charitable endowments and other institutions that already do not pay income or capital gains taxes.

To the extent that shareholder preferences still do matter, the persistence of stock market "players" myopic focus on short-term results will make a 10% annual tax free dividend look better than 10% tax free growth into the indefinite future. In fact ten dollars in your pocket today is worth more than ten dollars added to your company's assets coupled with the expectation that you will be able to get it into your pocket whenever you sell your stock. This will be the case even more if Bush succeeds in winning permanent repeal of the estate tax. Then the investor who keeps her or his stocks until death do them part, will leave a portfolio on which there is neither an estate tax nor a capital gains tax even if the other Bush proposals are not passed.

On balance it appears likely that the effects of the dividend and retained earnings tax proposals would be to replace a distinct bias in favor of not paying dividends with a new and much weaker bias in the opposite direction. Corporations had already begun to increase dividends in response to the shift in sentiment after the bubble burst. This might give the swing in the pendulum a little extra push. In any case the proposals would make stock ownership a permanently more attractive proposition by improving after tax returns to investors and by encouraging more rational behavior by both investors and corporations. An interesting side effect would be the increased value, at least to taxable investors, of companies that paid their full share of federal income taxes.

In the last three months the stock market has appreciated by twenty percent. Since everything else has not changed very much for the better or for the worse, I believe that stocks have moved from being very attractively priced to being quite fairly priced. From current levels stocks are likely to provide investors with a return around 8% a year for the next five or ten years. If everything goes perfectly for the rest of this year, stocks may earn a little more than

that over the next twelve months. On the other hand, if anything goes “wrong” stocks could easily drop as much as they did last year.

I continue to favor the same stock groups: companies that benefit from cyclical expansion and renewed inflation; companies that benefit from a shift of income in favor of lower income groups; companies that already sell at low price to earnings ratios and provide high dividend yields; companies able to participate in markets with high assurance of rapid growth. However, continued strength in the stock market or adverse developments outside the stock market will also raise the desirability of holding more cash and other defensive investments.

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