

Q: When is a Recovery Not?

July 2010

A: When state and local governments run out of stimulus money, when cash for clunkers disappears, when home buyers run out of tax incentive-money and when census workers' jobs wind down.

Congress in dilemma

Most of what plunged us into an economic deep-ding is still with us....but now, the props and buffers are gone....spent. And we have considerable new debt to show for it. The US Congress tried, but failed, to pave its way through the next election; indeed, it appears that incumbency will be their biggest re-election curse in 2010.

Pity Congress's plight: There are three elements on the federal budgetary teeter-totter that they can manipulate. They can:

1. Increase federal tax rates and/or sources of tax revenue... Yeah, right. Tax our way out of a slump. But, despite the absence of economic logic, increased taxes and hidden user fees are likely to happen during your holiday shopping this year.
2. Slash budgetary spending... Terrific. Dry up some of the nearly 25% federal contribution to the US economy.
3. *Hope* for growth in the private sector, which will increase federal revenue and help maintain the US's position in the global economy, which is quite a high perch. Recently published figures for 2008 showed the US's GDP was just over \$14 trillion, while the next four in line, Japan, China, Germany and France, together produced \$15.7 trillion. (And, we note, economic-might does not reflect the egalitarian perspective of the United Nations. These top five accounted for just under one-half of all the GDP on the planet.)

Despite the Gordian knot implied by this list, there actually is a shining example for political and economic courage: Britain's new Prime Minister has just hammered out a severe package of tax increases and deep budget cuts. The key to this move, we must note, was an election on May 11 that resulted in a "hung" Parliament (no majority) and a change of leadership, from Labour to Conservative, the first such change in 13 years/4 elections.

Taxes anyone?

Individual income taxes make up about 45% of all federal revenues. The top 20% income-earners among US taxpayers pay about 86% of all income taxes (up from 80% just prior to enactment of the "Bush tax cuts for the rich"). It is important to focus on those numbers because, if you're the President or a member of Congress, that top-20 group will surely be your target for solving the crisis in federal deficits/debt accumulation; of course there will be the mandatory, traditional scouring of federal expenditures to pounce on waste, fraud and abuse, but it will come to little consequence.

Although there is an apparent logic-fault against a tax increase in mid-recession, it will likely happen in the 2010 lame-duck session of Congress, if for no other reason than it will be so simple to do.....Simply allow "sunset" expiration of some hand-picked pieces of the 2002 tax cuts. The highest tax bracket(s) on married couples will likely go from 33% to 36% (on \$209,000 to \$373,000 net taxable) and 35% to 39% (on income above \$373,000). We did the math, using these revised bracket taxes. Say you're married, have \$650,000 of gross income and, after all deductions and exemptions, your net taxable income is \$500,000; your tax would be 7% higher. Expressed differently, you would pay \$10,000 more tax, which is 2% of your taxable \$500,000.

America's castles are still the recession-root

Heavily tax-subsidized*, single family US housing was ground-zero for what got us here in 2008 and it's still a deep, deep crater in the overall economy. When the special [additional, front-end] tax credit for home buyers expired in April, the home selling market not surprisingly fell off the table in May and again in June.

Fannie Mae and Freddie Mac, the dual basket-cases that the bond market always assumed were federal agencies, linger on, generating deficits, in the arms of federal "conservatorship" (a polite way to avoid the word "nationalization"). Despite the fact that the US Fed simply created a three-year guarantee out of thin air (to 2012) for Fannie and Freddie debt, bond buyers continue to value their *long term* paper as if it were also Fed-guaranteed. And despite intentions to do otherwise, the Fed is still

acquiring toxic mortgage securities (+\$1/2 trillion from a year ago), not to mention its continued purchases of new-issue Treasury debt, up \$90 billion vs. a year ago, to fill the gap when other buyers don't step up to help finance this year's federal deficit, which has already topped \$1 trillion for the 9 months ended June 30, 2010.

Update: The Fed's balance sheet has now ballooned to almost three times its "normal" level, before all this began in mid-2008; translation: the Fed has very methodically printed close to \$2 trillion of *fiat*-dollars in approximately 24 months.

***Beginning of the end for home mortgage interest deduction?**

It has been a very long term US tax policy to encourage home ownership, via allowing an income tax deduction for home mortgage interest... including that paid on one vacation home. For most people, mortgage interest represents the bulk of all their personal income tax deductions. [Note: Even though total deductions allowed to upper income taxpayers are limited, they still get to deduct at least 96% of their primary and second-home mortgage interest.] There may soon be serious Congressional debate about whether US tax policy should continue to subsidize *anything* other than bona-fide charities.

A fix for social security?

There will be deliberation and ballyhoo, when Congress likely acts to "index" the ages at which social security benefits become payable *to people who are now under age 50*. This will properly recognize the fact that life expectancy has, and will continue to, increase significantly. This single piece of legislation, which ought to be bi-partisan, can wipe away a large chunk of the US's un-affordable social security retirement liability.

Double-dip?

Maybe so. To be sure, current US economic problems are deep and daunting:

- Gloom over the persistent 10% unemployment and its 1-2 year outlook; even more gloom would be heaped up, if the massive under-employment and the no-longer-seeking-job figures were also tallied and reported. Estimates of this dark economic hole would add 7% to 12%.

- Housing valuation figures are so bad, seemingly without end, that despair over them has become systemic. Moreover, many homeowners' "underwater" mortgage debt situation is stifling their normal mobility in search of employment. There is chronic psychological impact on both job-seekers and families.... a result of generations of Americans who uniformly grew up, raised families, had grandchildren and even approached retirement under a bedrock presumption that today's home-value scenario simply wasn't one of the cards in the deck.

Daylight?

If your double-dip question is not about the economy, but instead about the prospects for the US stock market, there is a rather different set of facts to consider. Sales are down sharply from pre-2008, but Corporate America has so skillfully and quickly trimmed costs and managed debt that there are better than average prospects for steady, profitable bottom lines that will actually show at least moderate growth (S&P500 companies grew earnings in Q1 2010 by 13% over Q4 2009).

Corporate balance sheets are stunningly clean now and flush with cash (presumably forming a giant shock-absorber, because this horde is earning exactly nothing in today's money market). And, since US stock prices were recently forced to take a stinging bath, driven by European sovereign debt problems, the valuation of US shares just now is certainly not bubble-like, even assuming the engines of personal and business consumption will be running on fewer than all of their cylinders for another couple of years. Add in the apparent improvement in the psychology of people who have *not* lost their jobs and houses: they no longer see indications a layoff is just around the corner; hence, they are no longer stacking sandbags around every nickel of their personal income.

Recent market facts

In the 2nd quarter 2010,

- US equity markets lost \$1.8 trillion of capital from April 23 to June 30, mostly due to a fright over the un-resolved European debt crisis, while the Euro plunged (more) sharply, making new lows against the Swiss Franc. As this piece is being written in mid-July, the US Dollar index (vs a global currency basket) has declined for seven straight weeks.

- The S&P500 index was down sharply: -11.4% for the quarter and -6.7% for the year to date.
- All non-US stock indexes were negative by mid-teen percentages.
- Gold was up 11.5%
- 91-day Treasury bills returned 0.04% (and 0.12% for the past 12 months)!
- Re-construct Medicare/Medicaid payment systems
- Re-design the newly adopted health care insurance legislation
- Sell non-core public lands
- Sell/lease-back federal office buildings

Sovereign debt

We have saved the worst for last... the US's current *and projected* budget deficits are, as Fed Chairman Bernanke has said, "unsustainable". The President's bi-partisan Debt and Deficit Commission co-chairman a few weeks ago described the deficits as "...a fiscal cancer that could destroy the country from within."

Even assuming an economy that is "normal", the projected debt accumulations (measured in proportion to GDP) are not only gruesome, they are truly unprecedented for the US. By October of this year, the nation's debt will be at a point where it has been only once before: World War II. If the Congressional Budget Office's "likely scenario" projection is realized, the debt will quickly grow beyond our ability to service it within this decade. And realize this: current interest on US Treasury debt is at extreme, emergency-low levels, propped up by Federal Reserve Bank maneuvering that has simply reached its limits (zero interest rates) and must come to an end (printing fiat currency). The US Dollar will likely be allowed (even pushed) to continue its decline, in order to make US goods more attractive in foreign markets.

Besides the carnage-price involved in Korea, Vietnam, Iraq and Afghanistan, each snowballed into both fiscal un-affordability and eventual non-support by the taxpayers. Since their beginnings in 2001, the US's tally for its two currently active military occupations in the Middle-East has recently topped \$1 trillion (that's 1,000 billion) of disclosed appropriations.

The proportions of available long term fiscal fixes for the already accumulated federal debt will be purely political, but here are the ones with significant potential:

- Increase personal income taxes (via reduced deductions?)
- Increase corporate income taxes (about 12% of total revenue now)
- Devise new user fees and increase existing ones
- Increase social security retirement age
- Tax some portion of life insurance products