

The Good/Bad Compromise

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With the results of the election and long-awaited tax compromise between President Obama and congressional Republicans, the picture is clearing up: it's an aged and tired Uncle Sam kicking a can (or is it a barrel?) down a road. A cliché, sure, but an unavoidable one capturing the state of bipartisanship today: where everyone gets what he or she wants, the consequences to be dealt with later.

Oddly enough, this is good news for your money, or at least the best investors could have hoped for knowing true reform—or at least the needed changes any member of Congress would concede quietly and off the record—is an increasingly hopeless dream.

The tax compromise would extend all existing income tax rates for two more years beyond their scheduled December 31 expiration. Current capital gains and dividend tax rates (top rates for both are 15%) will also be extended for two years. “Stimulus” measures were added to the extensions, including a continuation of expanded unemployment insurance benefits through 2011 and a payroll tax cut by two percentage points. The estate tax will have a \$5 million per-person exemption and a top tax rate of 35% after December 31.

Though it didn't make headlines, the failure of an effort to assess the world's highest corporate tax rate (at 35%) on the foreign operations of American companies (wherever they do business and pay taxes) was big news for investors. The measure would have resulted in a reduction in corporate earnings power and competitiveness, especially among larger businesses. Had it passed, stock prices would have fallen, perhaps significantly.

Meanwhile the Federal Reserve's historic efforts to re-inflate the economy continue, including a new plan to print even more money. Euphemistically named “Quantitative Easing”, the plan will continue helping many a bank, businessman, and consumer live to lend and spend another day. Chairman Bernanke's kicking his own can, betting the currency ramifications of his war against deflation can be addressed...later.

On many levels, we disapprove how government has gone “all-in” with short-term efficacy as the only input in its decision making processes. We also have to adjust somewhat to this new reality: by far not a perfect environment, but still one in which capital can and will seek a decent return.

In previous notes we expressed our view of stocks being relatively cheap to other asset types. We are a little more confident in this outlook given recent developments. Consequently, we have increased exposure to stocks.

The soaring imbalances from Uncle Sam's check writing and Uncle Ben's printing press almost guarantee future economic and market woes—we are fairly sure of that. The can can't be kicked forever. However, those problems are for another time.

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