MONDAY, DECEMBER 17, 2012

The Holiday Speech

Let’s start with the headlines regarding the “fiscal cliff.” Without a resolution before the end of the year, drastic automatic changes will be take effect that will increase revenue and decrease spending. Another dimension to the cliff issue is the debt ceiling which will cap out in early 2013. Without an increase, the ability of the government to finance any further deficit spending would be sharply curtailed. Incidentally, our national debt is currently around $16.4 Trillion, but more on that later.

So, in a nutshell, here is what happens January 1 without a resolution:

- The Bush Tax Cuts will expire on December 31, 2012, the effect of which, will raise income tax rates for everyone. The Top tier will go from 35 to 39.6 percent. Capital gains rates and dividend rates will go up as well.

- The Social Security payroll tax holiday will expire on December 31, raising the rate from 4.2 percent to 6.2 percent.

- To fund "The Affordable Care Act" under Obama-Care, tax rates will increase on high-income earners and there will be an additional tax of 3.8 percent imposed on investment income, ie., dividends, interest income, and capital gains.

- Half of the scheduled spending cuts will come directly from the national defense budget.

- The eligibility to begin receiving federal unemployment benefits, last extended in February will expire at years end.

- Referred to as the "Medicare Doc Fix", the rates at which Medicare pays physicians will decrease nearly 30 percent on December 31st.

The most likely outcome of this current fiscal dilemma will be one of a series of short term fixes that, as they say in Washington, *“kicks the can down the road.”* However, as I see it, the ***real fiscal cliff*** is the continued deficit spending and the mushrooming national debt.

As I noted earlier, the current national debt is over $16 trillion. This is just the funded portion — the unfunded liabilities of the Treasury, such as Social Security, Medicare and student loans, make it much larger. The recent era of fiscal irresponsibility has thrown an additional $1 trillion or more on the pile every year. That is what we call the deficit. To fund the deficit, the Treasury sells notes and bonds. The biggest buyer of these debt instruments is not China or Japan. It is actually the Federal Reserve. The Federal Reserve has bought more than 70% of new Treasury debt issued this year. How do they do that? In simple terms, they do the equivalent of actually printing new money. Under normal circumstances that practice would spark rampant inflation. The fact that it hasn't suggests that maybe our dollar is actually undervalued, at least in relation to other world currencies.

The only reason that this staggering debt load hasn't crushed us is that the Treasury has been able to service it through historically low interest rates (well below 2 percent). These easy terms keep debt-service payments under $300 billion per year, or around 9% of total revenues.

At the current trajectory, the national debt likely will hit $20 trillion in a few years. If, by that time, interest rates return to 5 percent (a low rate by postwar standards) interest payments on the debt could run around $1 trillion per year. This sum would represent almost 40 percent of total current federal revenues and likely would constitute the single largest line item in the federal budget – more than current defense spending, and more than the current combined outlays for social security and medicare.

While all of this may sound like a doomsday scenario, it really doesn't have to be. For over 200 years the American economy has demonstrated remarkable resilience in its ability to bounce back from seemingly insurmountable problems. There have even been some creative suggestions on reducing the debt. In particular, I like the one from Ron Paul where he suggests that the Federal Reserve just destroy the notes and bonds on its balance sheet. If done today, that would eliminate $4 Trillion of the $16 Trillion debt. The money that was created to purchase the debt is already in circulation so there shouldn't be inflationary. Interesting proposal!

So, if you think this recent economic downturn is the worst since World War II, chances are you weren't born or working during the downturns of the 1970's and early 80's.

I started my career in the produce business in 1973 at an annual salary of $9000 and all the bananas I could eat. While the 9 year war in Vietnam finally wound down that year, Syria and Egypt attacked Israel and there was talk of Armageddon. We had the Arab oil embargo and gas lines. We invented a new term for our financial misery and it was called stagflation, which was short for a stagnant economy coupled with high inflation. This was also the decade of the "rope-a-dope" economy, a phrase made popular by Mohammed Ali's defeat of George Foreman in the 1974 title bout called "the rumble in the jungle." Unemployment peaked at 8.5% and inflation ran as high as 14%. By the end of the 70's decade, the rate on a 30-year fixed mortgage was 18%. And to top it all off, we were all running around wearing Leisure Suits and Bell Bottoms. Of course that was also the era of the hot pants and that wasn't too bad.

We finally came to our senses in the early 80's and things gradually improved. We threw out the rope-a-dope strategy, and came out swinging. Conditions improved for many segments of the economy in late 1983 and by early 1984, the economy rebounded and the United States entered one of the longest periods of sustained economic growth since World War II. Consumer spending increased in response to the federal tax cut. The stock market climbed as it reflected the optimistic buying spree. Over a five-year period following the start of the recovery, GNP grew at an annual rate of 4.2 percent. The annual inflation rate remained between 2 and 5 percent from 1983 to 1987 -- the lowest level in decades.

Looking ahead, of the major catalysts that I see contributing to economic growth in the decade ahead, none is more exciting or holds more potential than our domestic energy boom. All indications point to the United States becoming a net energy exporter by 2025 thanks to a surge in oil and gas production and dramatic improvements in energy efficiency. The process known as hydraulic fracturing and horizontal drilling are unlocking massive deposits of oil and gas trapped in shale formations throughout the country. The International Energy Agency recently forecasted that the United States will become the world's largest oil producer by around 2020, surpassing Saudi Arabia.

A by-product of increased oil production is natural gas. Natural gas is the cleanest burning fuel available today, and the U.S. is swimming in it. We have enough to last 92 years with current known reserves. Pipelines and storage facilities are being built at a frantic pace to handle this production. Worldwide demand for cleaner energy will lead to an increasing trade in ***"liquefied natural gas"*** which is achieved by cooling it to -165 degrees centigrade. Liquefied natural gas is much denser thus occupying less space making it cost efficient for export by trucks or ships. Currently, many western European countries are effectively being held hostage by Russia for over 80% of their Nat Gas needs which is delivered to them via pipelines.

Also, contributing to our recovery will be the resurgence of American manufacturing. Just recently, Apple Computer announced that they will produce Mac computers in the U.S. next year and are spending $100 Million to shift production of the line from China. Speaking of Apple Computer…

In the past 12 months, the 20,000 or so middle market manufacturing firms in the United States grew sales by more than six percent -- in total that's around $48 billion of new revenues -- and added around a quarter of a million jobs. The manufacturing middle grew more than three times as fast as the broader U.S. economy over the same period, and grew faster even than the developing economies like Brazil, India and Russia that we hear so much about.

Expanding exports and bringing manufacturing home will be essential to rebuilding our economy. However, the overhang of our expanding debt won't just disappear on its own. Most surely, as this debt is monetized, that is, money will either be printed or borrowed to pay the interest, the value of the dollar will weaken resulting higher inflation down the road, particularly for imported goods. That is all the more reason for bringing more manufacturing home. The traditional hedges for inflation, namely, commodities, gold, and real estate, look like good bets for the next few years.

Our tax system is the most convoluted in the world. There is something wrong when companies like Microsoft, Cisco Systems, and Oracle hold a combined sum of $115 Billion overseas compared to just $19 Billion at home. The 35% corporate tax rate is too high and just serves as a disincentive to putting it back to work at home. We need to declare a one-time tax holiday and repatriate this cash and make it available for investment in our domestic economy.

As for the personal income tax code, things are even more screwed up. Nearly half of households pay no income taxes at all. There are valid arguments to replace our current income system with a modified flat tax. We also need to take a fresh look at limiting deductions and the income limits need to be raised on payroll taxes if we are serious about saving the social security fund.

Out of the $2.6 Trillion collected from all federal taxes in 2011, $1.1 Trillion was from individual income taxes and $900 Million came from Social Security and Payroll taxes. My suggestion is a modified flat tax of 15/22, where everyone pays 15% on the first $50,000 of income with no deductions, and 22% on all amounts over $50,000, with itemized deductions on that portion capped out at 5% of income. This system would raise over $2 Trillion in revenue and we could eliminate the payroll tax altogether. Believe it or not, I actually worked through these numbers in great detail and sent over an unsolicited detailed proposal to one of the Republican candidates early this year. Unfortunately, my candidate didn't make the cut and I seriously doubt that my proposal made it to his desk.