ADDING VALUE

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We are facing a future that will be dominated by:

1. *Debt/Delevering* *(too much debt)*
2. *Globalization* *(a lessening stimulus)*
3. *The shady side of Technology* *(machines replacing workers)*
4. *Demographics* *(the inhabitants of this planet are aging)*

MIND YOUR B's AND T's (not your P's and Q's)

There is a great illustration to determine the size of one trillion dollars by pagetutor.com. Simply go to Google and type –what does one trillion dollars look like??? If you don't have the time, we can sum it up for you with the two-word understatement of the year: a lot.

It took the United States 193 years (1789-1981) to aggregate $1 trillion of government debt. It then took 20 years (1981-2001) to add an additional $4.8 trillion and, **in the last 10 years (2001-2011), a whopping $9.8 trillion has been added to the U.S. federal debt, for a debt total of over $16 trillion and counting.** This is the largest peacetime accumulation of total credit market debt in world history and most of the increase has occurred since the crash of the technology bubble a mere 10 years ago.[2]

So it is easy to conclude if One Trillion is a lot—Sixteen Trillion is monumental.

In Fiscal Year 2011 the U.S. Federal Government only took in $2.3 **T**rillion in total direct revenue and incurred a budget deficit of $1.3 **T**rillion.[3] This means the U.S. only collects enough in taxes to run 64% of the federal government. This situation has deteriorated even more recently; according to Jeffrey Gundlach in a recent conference call: "The U.S. has been spending more than 50% more than it's been taking in, in taxes."

$16 **T**rillion dollars of federal debt is a hard number to comprehend. The Institute on Taxation and Economic Policy micro-simulated a tax model via Citizens for Tax Justice. The New York Times published it December 9, 2012. The table demonstrates the 10 year impact on revenues due to new tax rates. It is as follows:

Current Marginal Tax Rates	New Top Marginal Tax Rates			
10%	10%	10%	10%	10%
15%	15%	15%	15%	15%
25%	25%	25%	25%	25%
28%	28%	28%	28%	28%
33%	***36%***	***36%***	***35%***	***34%***
35%	***40%***	***38%***	***37%***	***36%***

	Capital Gains	Dividends	Deductions	10-year impact on revenue ($ tril)			
Option 1	Raise Top rate to 20% from 15%	Tax at ordinary income rates	Limit value to 28%	**1.433**	1.226	1.061	0.901
Option 2	Raise Top rate to 20% from 15%	Raise Top rate to 20% from 15%	Limit value to 28%	1.314	1.117	0.96	0.807
Option 3	Raise Top rate to 20% from 15%	Raise Top rate to 20% from 15%	No limit	0.759	0.627	0.527	0.429
Option 4	Revenue impact of just income tax rate increases			0.442	0.304	0.2	0.098

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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[2]Kyle Bass. "The Central Bankers' Potekim Village." Hayman Capital Management. November 15, 2012. Pp 5.
[3] www.usgovernmentrevenue.com/yearrev2011_0.html

Our take away from this micro-simulation schedule and the pagetutor.com illustration is that it is important to keep track of the B's and T's (as in billions and trillions of dollars). The impact of raising $1.433 Trillion in revenue over the next 10 years (which is option 1 - best case) is the equivalent of collecting an additional $143 billion per year in taxes. With an annual budget deficit of $1.1 Trillion per year, $143 Billion from increasing taxes and limiting deductions on the top 2% may reduce the deficit but it does not stop the debt from increasing by $1 Trillion per year. At a current level of $16 Trillion, adding the, albeit lower, deficit to our current debt level over the next ten year period would leave the U.S. with a debt of over $26 Trillion in 2023! When the debt on the U.S. balance sheet represents about 5X the Federal Government revenues today and over 10X in the future, the question we should be asking is: How will we ever repay? The answer in today's terms is simple. We can't. (Please note that the final compromise on revenue raises only $0.8 trillion in revenue)

If we are unable to bridge gaps of $70 - $80 billion in the current fiscal cliff negotiations, it does not bode well for addressing the $1.3 trillion deficit. Ultimately, we must balance the budget, but to do that we have to work on more than this tiny issue of raising taxes on 2% of the population.

Unfortunately, the above analysis is only the tip of the proverbial iceberg. Most corporations have to publish financial statements under a set of conditions called the "Generally Accepted Accounting Principles." For years, the U. S. government has gotten by without having to produce the kind of financial statements that are required of most significant for-profit and non-profit enterprises. The U.S. Treasury "balance sheet" does list liabilities such as Treasury debt issued to the public, federal employee pensions, and post-retirement health benefits, BUT it does not include the unfunded liabilities of Medicare, Social Security and other outsized and very real obligations, including Obamacare.

In a WSJ editorial on November 27, 2012, Chris Cox (former chairman of the House Republican Policy Committee and the Securities and Exchange Commission) and Bill Archer (former chairman of the House Ways and Means Committee) stated:

"Fiscal policy discussions generally focus on current year budget deficits, the accumulated national debt, and the relationships between the two items and gross domestic product. We most often hear about the alarming $16 **T**rillion national debt (more than 100% of GDP), and the 2012 budget deficit of $1.1 **T**rillion (6.9%) of GDP. As dangerous as those numbers are, they do not begin to tell the story of the federal government's true liabilities…

The actual liabilities of the federal government—including Social Security, Medicare, and federal employees' future retirement benefits—already exceed $86.8 **T**rillion, or 550% of GDP…

When the accrued expenses of the government's entitlement programs are counted, it becomes clear that to just collect enough tax revenue to avoid going deeper into debt would require over $8 **T**rillion in tax collections annually, or more than one-half of the current GDP. This is the total of the average annual accrued liabilities of just the two largest entitlement programs, plus the annual cash deficit.

Nothing like that $8 **T**rillion amount is available for the IRS to target. According to the most recent tax data, all individuals filing tax returns in America and earning over $66,193 per year have a total adjusted gross income of $5.1 **T**rillion. In 2006, when corporate taxable income peaked before the recession, all corporations in the U. S. had total income for tax purposes of $1.6 **T**rillion. That comes to $6.7 **T**rillion available to tax from these individuals and corporations under existing tax laws.

In short, if the government confiscated the entire adjusted gross income of these American taxpayers, plus all the corporate taxable income in the year before the recession, it wouldn't be nearly enough to fund the over $8 **T**rillion per year in growth of U. S. liabilities…

Some public officials claim that we can dig our way out through tax increases on upper-income earners…In reality; that would amount to bailing out the Pacific Ocean with a teaspoon."

HOW FAR DOES TAX REVENUE GO?

We get confused also with all these billions and trillions that are bandied about as snippets of news, confusing annual deficits with accumulated debt and total income with total profits, so let's try these calculations one more time with some even simpler arithmetic for a one year budget for the U.S. government:

In 2011, the US spent approximately $10 **B**illion per day, or $3.65 **T**rillion per year, to run the country.

Households earning $250,000 and above, create $1.97 **T**rillion dollars in household income per year before taxes. In a charitable gesture, all these households

agree to a tax rate of 100% (leaving nothing for themselves to live on for the year); this keeps the government running for about 190 days. Net income from corporations comes to about $400 **B**illion. They are not so charitable, and are governed by a Board of Directors, so they only agree to give the U.S. Treasury 100% of income after expenses enough for another 40 days. America has 400 "evil" **B**illionaires with a combined net worth of $1.3 **T**rillion, confiscating everything they own, would fuel the U.S. spending beast until late fall. As they say, the numbers just don't add up…….

We can safely say that one **T**rillion dollars is a lot of money---so $16 **T**rillion of debt is alarming—and $87 **T**rillion of fully accounted for liabilities is catastrophic. (For someone starting from 1 it would take them over 2.7 million years to count to 87 **T**rillion!) Unfortunately, the amount of debt is one thing, but the burden of the interest payments of that debt is another. The Treasury now has a preponderance of its debt issued in very short-term durations, to take advantage of low short-term interest rates (or is it because of Bernanke's interest rate policy?) It must frequently refinance this debt which, when added to the current deficit, means that Treasury must raise about $4 trillion this year alone. In the post-credit crisis world of 2008, and particularly with Europe's sovereign debt in question, it is no surprise that the world was willing to accumulate U.S. currency and Treasury debt at near zero interest rates. This makes debt seem benign. So the debt burden will explode when interest rates go up. Interest expense could become the largest line item in the budget, crowding out even entitlements.

It has become increasingly clear that the policy response to the financial crisis by the European Central Bank, the Bank of Japan, and the Federal Reserve is to print money to finance fiscal deficits. Central bankers are feverishly attempting to create their own new world. As Kyle Bass states, "…a utopia in which debts are never restructured, and there are no consequences for fiscal profligacy. They have created Potemkin villages on a Jurassic scale. The sum total of the volatility they are attempting to suppress will be less than the eventual volatility encountered when their schemes stop working."

Most economists today seem to be following a Keynesian model of economics. Bernanke's recent edict that interest rates will stay low until unemployment reaches 6.5% seems prescient. But there are some rumblings toward the writings of another less known economist, Friedrich van Hayek. In 1944, he wrote the Road to Serfdom. Its message was that all forms of socialism and economic planning lead inescapably to tyranny. The genius in the book was the argument that serfdom would not be brought about by evil men like Stalin or Hitler, but by the cumulative effect of the wishes and actions of good men and women, each of whose interventions could be easily justified by immediate needs. Although we advocate social liberalism, we need to get there through fiscal responsibility.

In an attempt to understand some consequences of the fiscal quagmire in which we stand, it is helpful to review history. We cannot risk counting on the problems in the rest of the world to make Treasury securities a safe haven forever. As Bill Gross states: "America is simply the cleanest dirty shirt." Alexander Hamilton, as our first Treasury secretary famously stated that one of our nation's greatest assets was its ability to issue debt. We honored our Revolutionary war debt as the "price of liberty." Historian John Steele Gordon wrote that our nation's ability to issue debt helped preserve the Union after the Civil War and defeat the totalitarian governments in the 1940's (just as Hayek was writing his economic treatise). We need to ask ourselves as citizens of the greatest nation on earth whether staying on our current fiscal path will wind up being completely unmanageable. Let's hope that some sanity comes to Washington in the near future. You can either pull the bad tooth, or you can provide pain killers and symptom relievers, and let the problem rot indefinitely.

Is there no Good News?

Well we just can't end this newsletter on such a dismal note. A few items deserve mention:

- The first is the possibility that we are just too negative. Macroeconomic forecasting is very complex and just maybe GDP and human capability will find a way to grow in ways that cannot be foreseen. For instance, who foresaw the Internet?
- The second is that some asset prices are reasonable, at least relative to other investments and to history. As one of our manager's recently stated: "The next time someone asks you how you can buy stocks without incorporating a view on the economy, ask this: The stock market has more than doubled since the 2009 bottom, is up nearly 50% in the past three years, and is up over 30% in just the past year through 9/30/12. How many investors became more positive on the market because of their economic outlook? The only people I hear asking this question are the ones who are

shading their expectations more negatively. It hasn't worked for them in the past four years, and we don't think it will work for them in the future." Another manager stated even more succinctly: "If we cannot find opportunities in this market, we shouldn't be in the investing business."

- The final factor is this: investor psychology is much curtailed from pre-crisis levels. This is very healthy from a buyer's point of view.

These are uncertain times—no doubt about it. The macro outlook is quite unclear and lackluster. On the other hand, these worries may be offset to a degree by the reasonableness of asset prices and the low level of investor confidence. An outlook characterized by slow growth, potential serious problems and great uncertainty should call for more fixed income investments than equities, more pursuit of value today than growth tomorrow and more safe investments and less use of leverage. However, safe investments have been bid up, such that the future returns on them are paltry at best. If you buy ten-year U. S. Treasury notes today (directly, through annuities, through ETF's, through bond mutual funds, etc.) at a 1.7% yield, it is hard to imagine environments other than depresssion and deflation in which you'll be happy with the outcome.

This is not a black and white world where it is reasonable to insist on safety and eschew risk. Unless you consider loss avoidance as overwhelmingly important and you can truly forgo making money, the approach for today has to balance risk aversion and the careful pursuit of return. The smartest response still consists of investing in some area of the capital structure of well-priced corporations which have the best chance of adjusting to environmental phenomena such as inflation, dislocation, and competition. We must also all adjust downward our expectations of future returns.

So we continue to work diligently and tirelessly to navigate the volatility and instability in the marketplace, with our key goals of preserving your capital and generating an above-average risk-adjusted return when compared to passive indices within your stated and observed time horizon.

Thank you for your continued support.

Happy New Year!

Sincerely,

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