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ASSET MANAGEMENT

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It was the best of times, it was the worst of times,
it was the age of wisdom, it was the age of foolishness…,
it was the spring of hope, it was the winter of despair… –
in short, the period was so far like the present period.
Charles Dickens, *A Tale of Two Cities*

In this letter, we plan to examine why income inequality has been increasing since 1980 and the attendant investment implications. We believe a better understanding of this long-term trend will help investors better navigate the investing environment over the next decade. We have concluded that a) economic inequality is currently at extreme levels, b) stagnant wage growth and the "financialization" of the U.S. economy have been the primary drivers of increased economic inequality, and c) the likelihood is high that, within the next decade, we will see a trend reversal as a result of higher interest rates and redistributive government policies.

Our clients have accumulated savings through a lifetime of hard work, good judgment, and frugal spending habits. Their nest eggs are both hard earned and well deserved. In this letter, we are sensitive that we will be talking about the "1%" of income earners or asset holders which includes most of our valued clients, and consequently we want to say clearly that our analysis here is not at all intended as a finger-wagging exercise. Rather, we believe it is important to understand economic and social reality in order to prepare for the likely investment environment of the future.

During the third quarter, strong stock market returns again were the result of the Federal Reserve's reflationary efforts undertaken in response to the 2008/2009 Financial Crisis. Since the market bottom in March 2009, as a result of unprecedented monetary stimulus the U.S. stock market has generated a total return of more than 100%. As it turns out, over 80% of U.S. stock market wealth is concentrated amongst just 10% of the U.S. population.[1] Therefore, it is little wonder why financial asset price inflation is having little impact on the larger economy. For many Americans without a substantial investment portfolio who depend instead on good jobs for their economic well-being, the disappointingly soft business environment since 2009 has proven to be challenging, to put it mildly. Approximately 11.7 million Americans remain unemployed, while another 12.7 million are underemployed. Furthermore, the majority of the jobs that have been created during the recovery have been low paying service sector jobs. Also, almost 48 million Americans are dependent on the U.S. food stamp program.

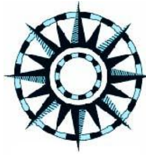
Benchmark Performance

Indices	6/30/13 - 9/30/13	9/30/12 - 9/30/13
S&P 500	5.24%	18.38%
MSCI World	5.02%	23.06%
Gold	8.40%	-25.18%
Barclays U.S. Aggregate Bond Index	0.57%	-1.66%

Source: Factset

For the last several years, we have maintained that the economy cannot grow at a normal pace because the economy is overburdened by high debt levels. For much of the U.S. population who do not own stocks, whose incomes have stagnated, perhaps for decades, and whose housing wealth was destroyed by the Financial Crisis, the level of debt they are coping with (relative to income) is far worse than the national average. Until those debt ratios decline, the prospect of a healthy and sustainable economic recovery remains dim, in our opinion. We continue to believe the stock market is booming far less due to the economic recovery and far more due to excess liquidity provided by the Federal Reserve.

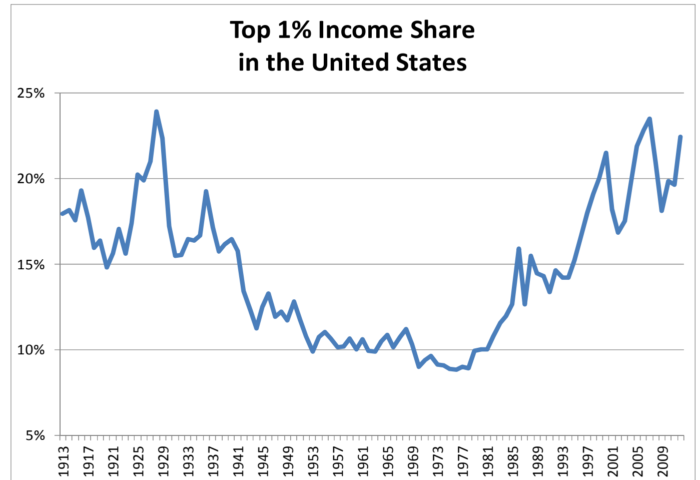
[1] Source: Economic Policy Institute.



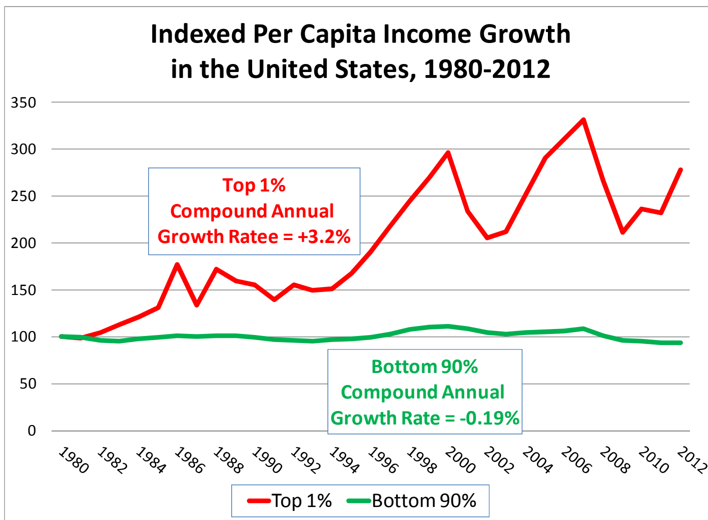
Increasing Economic Inequality

The stark contrast between the robust strength of the stock market and the disappointing strength of the larger economy, in our view, reflects the ongoing hollowing out of the U.S. middle class and the increasing chasm between the economic well-being of the wealthy, at one end of the spectrum, and the lower income portion of the population and the outright poor in the United States, at the other end. Economic data supports the notion that the gap in the economic circumstances of Americans has reached extreme levels. Depending on your viewpoint, the current level of income inequality the U.S. is experiencing is an important source of the larger political, social, and/or moral problems the country faces. Our intent in this letter is to address the economic consequences of increasing levels of income and wealth inequality and to suggest a number of potential investment implications.

The chart to the right shows the share of national income (including capital gains) earned by the top 1% of taxpayers in the U.S. over the past century. You will see a peak in the share of income occurring just before the Stock Market Crash of 1929. Following the Crash, the share of income earned by the top 1% gradually declined throughout the Great Depression and World War II. Income inequality continued to decline and/or plateau during the post-war period through the first part of the 1980s. Since then, income disparity has increased substantially and has reached a level that is presently commensurate with the income disparity that existed at the time of the 1929 Crash.



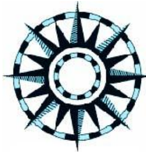
Source: Piketty and Saez and the World Top Incomes Database. Pre-tax income figures include capital gains and exclude government transfers and nontaxable fringe benefits.



Source: Piketty and Saez and the World Top Incomes Database.

In the chart on the left, per-capita income was indexed since 1980. What this chart shows is that the top 1% of income earners realized annual increases in real income of more than 3% per annum, while, at the same time, the bottom 90% of income earners experienced a *decline* in real income. In effect, more than 100% of all real income gains (adjusted for inflation) in the U.S. accrued to the top 10% of income earners. We would also point out that the figures above measure pre-tax income. As marginal tax rates have declined for high income earners since 1980, the after-tax discrepancy between the top 1% and the bottom 90% is even larger than the chart indicates.

In our view, it is important to look at wealth disparity in addition to income disparity. In the United States, the share of wealth owned by the top 1% is far higher than the share of income generated by the top 1%. The top 1% in the U.S. owns approximately 40% of the wealth and approximately one-half of the country's total ownership of stocks, bonds, and mutual funds. This high level of wealth concentration is the most likely reason why the booming stock market in recent years has had so little effect on the larger economy.



The Drivers of Income Inequality

What happened that caused the share of income and wealth to become so concentrated among so few people at such extreme levels? There is no single answer to this question, but it seems to us that increasing inequality has been driven by a) globalization, which has led to stagnant wage growth, b) easy money, c) tax policy changes, and d) the increasing disparity in educational outcomes. All of these trends began to develop during the 1975-1985 period:

1) Stagnant Wage Growth: Over the past century, the prevalence of well-paying domestic jobs was the driving force initially behind the formation and, more recently, behind the dissolution of the U.S. middle class. In the decades immediately following World War II, the U.S. economy grew quite strongly, and the gains from that economic growth were widely shared by labor, by management, and by investors. Much of the world's industrial capacity was destroyed during World War II, and, as a result, American manufacturing industries enjoyed limited competition and strong pricing power after the war. The Post-WWII period was the heyday for the American worker, particularly in manufacturing industries where workers could command attractive wages.

Source: St. Louis Federal Reserve Bank.

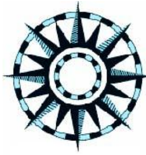
Beginning in the 1960s, U.S. manufacturers began to experience increasing competition from foreign companies located in Japan, Mexico, South Korea, Southeast Asia, and, more recently, China. While the U.S. pursued a free trade policy, its trading partners pursued mercantilist policies. Foreign manufacturers increased their exports to the U.S. based on lower labor costs, especially for products where labor costs were an important cost component. Unionized manufacturing jobs were exported from the U.S. to countries with a meaningful competitive advantage in labor costs. In addition, automation made many manufacturing jobs obsolete not only in the U.S. but around the globe. As a result of competition from low wage countries and automation-driven labor saving technologies, unionized manufacturing jobs declined as a percentage of total jobs, although these losses were offset partially by gains among unionized public sector workers.

Since the mid-1970s, economic returns to labor in the U.S. have been steadily declining, to the detriment of income earners in the bottom 90% who depend on employment wages for the vast majority of their income. The chart above shows that U.S. employment wages as a percentage of U.S. GDP have been declining since the 1973-1975 recession. The American worker has suffered from a lack of pricing power in wages as a result of globalization, automation, and a resulting decline in the strength of private sector labor unions, particularly in manufacturing.

More recently, as computer and communication costs have declined and the Internet has come into greater use as a productivity tool, labor's pricing power has also been declining, even among high value service sector jobs. Low level legal jobs, accounting jobs, computer programming jobs, and even medical jobs are increasingly being outsourced to countries like India, China, and the Philippines where skill levels are reasonably high but labor costs far lower.

Today, negotiating power is firmly in the hands of multi-national companies who can quickly and cost effectively relocate and automate operations to reduce costs (both labor and taxes), and the downward trend of U.S. wages as a percentage of GDP reflects this difficult reality.

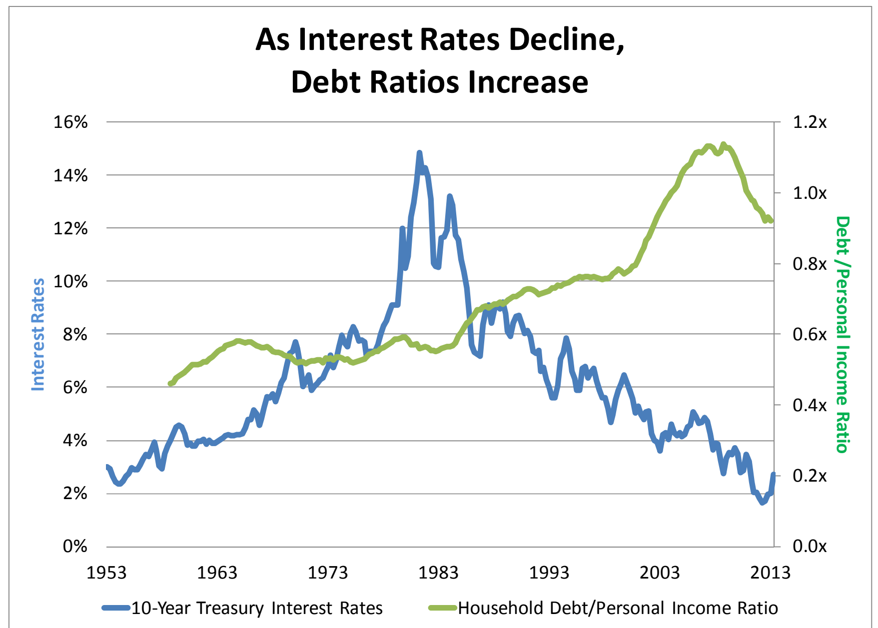
2) Easy Money: If the decline of the middle class was largely driven by a loss of manufacturing jobs, the rise of the 1% has been largely driven by the "financialization" of the economy over the past three decades. The year 1981 marked the peak in long term interest rates (remember 18% mortgages?) and the starting point for the unrelenting credit



boom which continues through the present moment. Financial sector profits have surged from less than 5% of total domestic corporate profits in the early 1980s to over one-third of total domestic corporate profits today. Declining interest rates have boosted the value of financial assets, from bonds to stocks to commercial office buildings. For financial sector professionals in the business of brokering, underwriting, securitizing, and valuing financial assets, it has been "the best of times."

Declining interest rates and easy money have greased the wheels for households to increase debt levels and to refinance mortgages. While debt levels have increased in all segments of society in the United States, according to two IMF economists, Michael Kumhof and Romain Ranciere, it is those households which have seen their incomes stagnating the most since 1980 that have increased their debt levels the most in order to sustain high consumption levels. The household debt/income ratio peaked in 2007 at about 1.1x and has declined somewhat in the aftermath of the Financial Crisis as a significant portion of consumer debt has been written off.

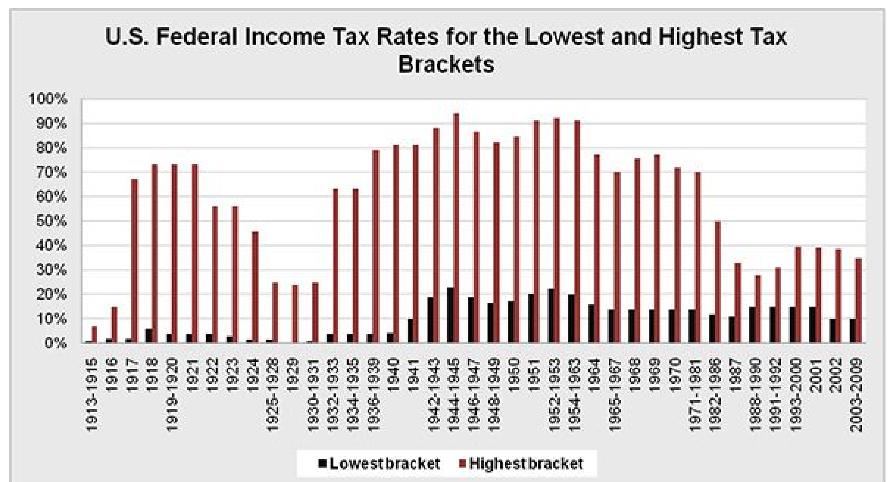
The Federal Reserve, Congress, and Wall Street have conspired to create two financial bubbles just during the past fifteen years. First, the Dot-Com Stock Bubble and then the Housing Bubble created enormous speculative wealth fuelled by easy money and Wall Street's money raising machine. While the Dot-Com Bubble was troubling enough, the Housing Bubble involved fraudulent derivatives, compliant regulators, and unprecedented leverage taken on by households and financial institutions alike. In the recessionary aftermath, the housing bust particularly hurt the lower 90% of income generators, due to widespread job losses and because, for most families, their house is their primary financial asset.



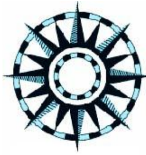
Source: St. Louis Federal Reserve Bank.

3) <u>High taxes on labor, declining taxes on capital:</u> Beyond the decline of the manufacturing economy and the rise of the finance economy, tax policies exacerbated pre-existing disparities of per capita pre-tax income between the top 1% and the bottom 90%.

As demonstrated in the chart on the right, after the stock market crash of 1929, policy makers hiked marginal tax rates significantly in order to fund New Deal government programs and subsequently World War II. The highest income tax bracket remained above 70% until the Reagan Administration. Since 1980, the



Source: U.S. Internal Revenue Service



highest marginal income tax bracket has declined from 70% in the 1970s to 35% through 2012.

Furthermore, long-term capital gains tax rates have been capped at lower tax 3 2013rates (15% until 2012 and 20% currently) than ordinary income tax rates. Low capital gains tax rates certainly stimulate investment, but the benefits of these policies have primarily accrued to the top 10% of income generators. On the flip side, high tax rates on labor create a disincentive for both employers to hire and prospective employees to opt to work.

4) Education Inequality: The disparity in incomes between the top 1% and the bottom 90% has had a discernible effect on widening educational outcomes, with the differences increasing since 1980. Sean Reardon, a Professor of Education and Sociology at Stanford University, has studied this issue:

> Consider two children, one from a family with income of $165,000 and one from a family with income of $15,000. These incomes are at the 90th and 10th percentiles of the income distribution nationally, meaning that 10 percent of children today grow up in families with incomes below $15,000 and 10 percent grow up in families with incomes above $165,000. In the 1980s, on an 800-point SAT-type test scale, the average difference in test scores between two such children would have been about 90 points; today it is 125 points.[2]

This trend is worrisome because, compared to the 1950s, education is far more important today in obtaining a high paying job. If the ability to earn a high income is dependent on getting a good education, which in turn is dependent on parental income, increasing economic stratification becomes increasingly problematic for the individuals involved and for society as a whole.

Investment Implications

As contrarian investors, we are constantly on the lookout for trends which seem to have reached extreme levels and are ripe for reversal. Notwithstanding the absence of an obvious catalyst in sight, given the Dickensian contrast between the top 1% of incomes and the bottom 90% of incomes, we nonetheless expect that inequality is likely to moderate in the future. In short, we are anticipating a trend reversal, although the timing is uncertain. The catalyst for a reversal could be government policies, higher interest rates, and/or merely an elevated level of social unrest.

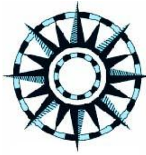
Just briefly, our view is that the economy cannot experience a sustainable recovery with high levels of debt, particularly since the bottom 90% of income generators are especially burdened by high debt ratios. High debt levels represent a headwind to economic growth because companies depend on consumers to purchase their products and services, and discretionary purchasing power today is severely hampered by an extraordinarily high percentage of personal income being funneled towards debt service.

High debt levels also increase the risk of economic instability. The more debt a person or household has, the more devastating a job loss becomes. Also, the more debt a person or a household has, the more devastating high interest rates become for those with high debt ratios. As a result, a business slowdown or higher interest rates would likely result in widespread loan defaults and perhaps a deep recession. We believe that the worry over potential deflation keeps the Fed up at night.

Between slower economic growth and higher economic instability driven by excessively high debt ratios, it is easy to understand why the Federal Reserve likely will keep interest rates low, which should continue to be good for debtors, bad for creditors (and fixed income investors), and likely result in reduced purchasing power for the dollar. Similarly, it is also easy to understand why we will continue to see increasing political pressure to facilitate householders to restructure their debts. Thus far, as noted above household debt ratios have declined slightly, but we are still early in the process.

Another important implication of extreme income inequality is that cronyism and corruption increase. Wealthy households at the top 0.1% are able to influence legislation, regulation, and elections through contributions to campaigns,

[2] Source: New York Times, April 27, 2013.



think tanks, and advocacy groups. Corporations, too, are able to influence political outcomes by lobbying and funding advocacy groups. The influence of special interests tends to increase rent-seeking activities, which leads to questionable legislative outcomes that disproportionately benefit the largest corporations and the top 1% of household incomes.[3] A good example of this was the Troubled Asset Relief Program (TARP) which protected financial institutions while they were writing off bad loans during the 2008-2009 Financial Crisis. Cronyism distorts the pricing mechanism of the marketplace and leads to poor or inefficient capital allocation decisions in the economy which in turn reduces economic growth and makes the economy less stable. As a result, even more pressure is placed on the Federal Reserve to paper over the consequences of this capital misallocation by keeping interest rates low.

The historian, Plutarch, described Athens of 594 B.C. in terms which could be just as applicable to the U.S. today. Plutarch said that "the disparity of fortune between the rich and the poor had reached its height, so that the city seemed to be in a dangerous condition." Like Washington D.C. today, the partisanship that existed at that time was acrimonious; wealthy Athenians wanted to keep their current position and protect their property, and poor Athenians felt disenfranchised and saw their economic position worsening every year. Athens was eventually saved by Solon who, according to historians Will and Ariel Durant, devalued the currency to reduce personal debts, established a progressive income tax whereby the rich paid at a rate twelve times the rate paid by the poor, and reorganized the court to reduce corruption.

Turning to recent history, the 1929 Crash was an important catalyst in alleviating income inequality in the United States. During the Great Depression, the American people elected Franklin D. Roosevelt as President with a Congress who supported his efforts in reducing income inequality. FDR signed the National Labor Relations Act, giving workers the ability to bargain collectively. He set the first minimum wage, banned child labor, and signed the Social Security Act, boosting incomes among the less well-off. To protect retail investors and depositors and reform the banking system, he signed the 1933 Banking Act, which included the Glass-Steagall provisions that separated commercial banking from investment banking. FDR devalued the currency, easing the burden of debtors. Finally, under Roosevelt's presidency, the highest marginal income tax rates were increased from 25% to 80%.

How does history apply to the current era? Is the present period a replay of past periods of "excess", and were these periods indeed "so far like the present period"? We have listed ten developments below that could occur, in our view, over the next decade:

1. Many tax deductions, which benefit high earners, likely will be eliminated and/or marginal income tax rates likely will increase, quite possibly to very high levels.
2. The Illinois Constitution which mandates that a flat tax be applied could be amended, and high income earners in Illinois could see state income tax rates double to 10% or more. This may occur in other states as well.
3. We expect to see new taxes on wealth and higher tax rates on capital gains, gifts, and estates.
4. Retirement accounts are vulnerable to some combination of new taxes and/or investment limitations..
5. Trade protectionism should rise, so that demand from U.S. consumers can be more easily served by manufacturers located domestically.
6. With stronger trade protections in place, the labor movement could experience a resurgence in the U. S.
7. The financial sector likely will decline as a percentage of GDP, driven by higher interest rates and structural reforms that limit the ability of money-center banks to generate profits from financial speculation.
8. The dollar likely will be devalued in order to reduce the burden of debtors, including local, state, and federal government debtors.
9. Legislation likely will be passed and executive orders likely will be issued which would make it easier for consumers to restructure their household debts.
10. Means testing likely will apply to Medicare and Social Security.

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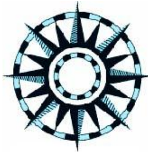
[3] "Rent seeking" is a term used to describe efforts to manipulate the legislative and regulatory environments to increase economic income.



Given that most of these trends will negatively impact those Americans with wealth, we expect our client base generally will not benefit from these developments. As your investment advisor, we are particularly attuned to the expected devaluation of the dollar and the detrimental impact that higher interest rates will have on the value of financial assets. We are underweight long-term bonds and leveraged financials that will be hurt the most by a lower dollar and higher interest rates. We are similarly underweight stocks which target high income consumers. Finally, we are redoubling our efforts to minimize and defer your capital gains taxes, recognizing that capital gains tax rates have already risen and potentially could rise further. To be sure, we are ever mindful of the need to protect the real value of your liquid assets.

As always, we are grateful for the trust you have placed in us to manage your capital.

Sincerely,

Pekin Singer Strauss Asset Management

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