FIDUCIARYVEST
Investment Strategies for Fiduciaries

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Chinese New Year
January 31 marked the Chinese New Year (#4712). The Year of the Horse; unfortunately, its early going is beginning to look a little like the Year of the Dog.

China's GDP growth rate is dropping fairly dramatically, from double-digits in the early 21st Century to 4-5% now. In a mere 20 years, China has moved from a giant, economically sleepy dictatorship, the population of which struggled to feed itself, to today's dynamic (though government controlled) manufacturing engine that has produced not only a sizeable, legitimate middle class but also a Top 1% income group. All of that progress was based on a limitless supply of very cheap labor….China's vast and rapid awakening to the modern world was just in time to grab a share of the global Tech Revolution. The youth of dirt poor farming families fled in massive numbers to job opportunities in the big cities.

China's securities market is still viewed as "emerging" by the "developed" world. But, it's turning out that the most prominent emerging thing about China's economy is a *ton* of government debt. In the 1990s, total US federal and local government debt equaled about 1/3 of total world GDP growth, while China's ratio was only 10%. But, when the 2008 world recession hit, China panicked, fearing that its world-beating growth would suddenly run amok. By 2011-13, China's debt/ global GDP growth ratio had soared to 36% and was still rising. The US's ratio had fallen to 19%, despite the fact that, as we all know, the US's federal public debt had risen from under $10 trillion to $17 trillion after 2008, while the GDP itself was actually stagnating, or shrinking. Even with such a debt-bomb and dismal GDP growth, the US hasn't yet breached a 100% debt-to-GDP ratio.

China's debt is now more than 230% of its GDP! A number of economists have published views that public debt loses its leverage, i.e., it becomes an albatross, when it goes above 100% of GDP. The not-so-evident underlying cause of China's public debt explosion is its local provinces. Local politicians, apparently, had an open option to pump unlimited (borrowed) money into all things structural.

If China is indeed walking near an economic chasm, then the rest of the most prominent emerging markets (Brazil, India, South Africa, Indonesia) are swinging on a thin rope, while Argentina appears to be headed for self-destruction… again. Signs of troubles for China's currency, not seen in the past, are getting louder. (And, if any major currency weakens, the US dollar will strengthen which will not be good for the economy, although it does form a tailwind for dollar-holders' international investments.)

Abe, Abe
If things are looking a little stormy from China's shore of the Sea of Japan, the Japanese side is having the time of its life. After 15 years of dismal market performance, economic deflation and political revolving doors, just before the dawn of 2013, Prime Minister Abe(re)took office. His first year is now history and what a year it was! He has apparently put his full faith and credit into a US Fed-style money printing binge and the result: no more deflation. Abe, who, seven years earlier, had been driven from office after exactly one year, now enjoys a public approval rating over 60%. And, just as the Fed was able to pull off in the US, the Bank of Japan's 2013 money printing has provided fuel for its stock market to run up an astonishing 57% in 2013.

Globally un-equal Income – a slippery Swiss slope
International financial leaders representing those who actually make their living while occupying Wall Street (and equivalent streets in other major economies), gathered in Davos Switzerland last month at the annual, modestly named World Economic Forum. They made Income Inequality a

prominent agenda topic. In fact, the Forum's published list of the top 5 Global Risks (in terms of likelihood) ranked "Income Disparity" as #1 for 2014…for the third straight year. To put the list into perspective, the other four top 2014 Global Risks were: #2: extreme weather events, #3: unemployment/ under-employment, #4: climate change and #5: cyber attacks. During the eight-year history of the Forum's list, Income Disparity curiously didn't show up until 2012. The entire Risk List may sound as if it has been devised by way-left-of-center American politicians, but it was hardly that. In fact, the gathering was attended exclusively by folks who are, or represent the Global Top 1% of earned income.

The income-gap discussion hinges on a standard premise that Income Inequality is a festering societal condition. As we reported at the time, last winter's Occupy Wall Street movement gave the appearance of being spontaneous, mainly because it was led by no one in particular. As a result, participants never came to agreement on their goals. The surviving principle seems to be that the street-occupiers were speaking on behalf of the bottom 99% of all those who, because of their sheer mass, claim entitlement to a larger slice of the national economic pie. But, any actions they wanted the government or Wall Street to pursue in order to relieve the economic disparity were not only unclear, but unstated.

In today's tweeting world, where abrupt crudeness has become an art-form, Income Inequality suddenly jumped from being a non-existent phrase into full-throated pop usage; it seems to levitate, defying recommendations. Media commentators universally took up the chant without bothering to define it. The *Wall Street Journal* editorially concluded that, while the income gap is a problem which is, and has been growing, there is no evident solution.

This nation has millionaires and billionaires who, according to the President and other prominent advocates, could pay "a little more" in taxes, the idea being that personal accumulation of a million or billion dollars is far more than enough to meet any family's "needs". There are, however, some existing dis-proportions on the other side of this discussion.

Of the 136 million US income tax returns filed for 2011 (latest data), nearly half of them generated zero income tax, or even negative tax* for Uncle Sam.

*Negative income tax occurs when the household's income tax is smaller than the Earned Income Tax Credit which can be claimed by low-income filers.

A fairly big share

The top 1% of all taxpayer households (incomes above $389,000 in 2011, per IRS) has been a relatively constant number… 1.3 million of them… for a number of years. In each of the past five reported years (through 2011) *the top 1% of household incomes paid between 19% and 23% of total collected US income tax*; the top 5% earners consistently pay about one-third of all federal income tax and *the top 10% pay close to half of it.*

To put these figures in perspective, if we had increased the tax rate to 100% of the top 1%'s reported gross income for 2011, we would have collected $1.2 trillion more than the $365 billion we actually did collect from them. That extra take would have just about balanced the federal government's budget for 2011, but what would that have done for the bottom 50%? Absolutely nothing. So, collecting more tax from the top 1% will not affect the Inequality problem at all, unless the government simply re-distributes those additional tax collections. Every year.

Critics of these rich-tax statistics have their own math: they argue that low income folks pay significant, non-refundable payroll taxes, the result being that 'working people' typically pay a higher percentage than most fat cats. But, so-called payroll taxes (Social Security and Medicare taxes)are actually a uniform 7.65% for everyone who earns an income (up to $117,000).The Top 1%'s average 2011 income tax rate on their total gross taxable income was 23.5%... the highest percentage paid by any income group. And, beginning with 2014, the average tax rate on the Top 1% will likely rise by 2-3% (a +10% change).

That said, it will not be surprising if, after the 2014 elections, there is a political thrust toward removing a portion of the tax-favored treatment of long term capital gains.

Policy, or practicality?

Columnist David Brooks wrote in the New York *Times* that the growing affluence of the rich is not causing, or contributing to the income insufficiency of the poor. America's financial under-class, he said, is the un-surprising result of single-parent/no parent families, crime riddled neighborhoods and dysfunctional schools, among other social infections. Governmental policy, he concluded, has to address those roots, in order to move toward getting on top of the problem.

Government policy is one ingredient, but probably not the key element, in practical terms, of any meaningful shift toward restoring robust growth of the American middle class. Here is why: We have been here before. And we have already tried and failed at using our government to do away with poverty and its wretched bedfellows. President Lyndon Johnson's "Great Society – War on Poverty" initiatives in the 1960s taught us that good intentions, backed by tons of government deficit-money, logically produced a generation of crafty middle-men and middle-women who were mostly about the political power that accrues to those who oversee government disbursements. Indeed, the poor folks of Johnson's era got some money too, but because the Great Society lacked investment qualities, its impact was flushed away, along with other routine annual government expenditures.

The school of soft knocks

Of the factors in Mr. Brooks' list of ills, the dysfunctional schools problem stands out as the core… the likely cornerstone of a long term, targetable way to address the entire list. Good jobs will follow quality education. A large number of well-paying jobs have left America. According to some outspoken US industrial leadership, a portion of those exiled jobs went unfilled in the US, owing to an inadequacy of secondary education, compared to a number of other countries.

History makes it clear that workable solutions to national needs are rarely, if ever, rooted in politics, government machinery or bureaucratic management. It's not that government cannot help, but if it controls, it kills the likelihood of *investment* and so goes the chance for serious movement toward long term abatement of America's personal income balance.

Corporate America has a clearly vested motive for actively supporting the elevation of America's education network. In a highly competitive global marketplace, the quality of the emerging labor pool produced by the primary and secondary education system is crucial. It is therefore not a charitable motivation that would drive big businesses to become active participants in long term education initiatives. The order and commitment which industry can bring about could steer the wagon to turn the corner and face the sunlight that will foster more jobs paying solid, middle-income wages.
Two key underpinnings can be provided by corporate/government resources: (1) incentives for low income participants to set and achieve economic goals, supported by (2) pertinent education. (Long term sustainability would likely be fed by two logical offshoots: personal pride and family bonding.) And, for both the governments and the corporations, there is a massive hard-dollar dividend to be generated from having a robust, expanding middle-income population segment.

The 1%-ers who gave 50-99%

The foregoing discussion is in perfect accord with one totally non-governmental, voluntary resource that is made up entirely of big-time money, contributed exclusively by Top 1%-ers. The "Giving Pledge" group headed by Bill Gates and Warren Buffett is a still-expanding number of more than 100 billionaires, most of whom were personally recruited by Microsoft co-founder Bill Gates; each has signed a pledge to commit a *minimum* of 50% of their entire wealth into charitable causes. According to Gates, not many of the pledges are merely 50%. Mr. Buffett, likely the richest of them all, has plunked in 99% of his tens of billions. Buffett is also probably the oldest billionaire on the pledge list, while Facebook founder Mark Zuckerberg is one of the youngest. The total current value of all the pledges is not published, but it is likely that the number will reach $1 trillion soon, if not already. Only in America: There are actually some critics who have snarled that The Pledge is just another super-rich tax gimmick.

The small economy…pennies from hell
We have wondered for many years why the federal government continues to pour money into the 2¢ cost of minting of one-penny coins….over 600 of them are estimated to be in circulation for every warm body in the US. Of that number of people, how many of them care to have, or use these copper-colored, pocket-hole-creators? How many resent waiting to get four pennies back (instead of a nickel) from a $4.96 transaction at McDonalds? And how many would gladly pay $5, instead of $4.98? There are actually two bills languishing in Congress that would eliminate pennies, but little popular political support exists on either side of the issue.