Dysfunction Junction

John Gustafson – 9 January 2013

Hearkening back to the note we sent around the day after the election where, despite all the *sturm und drang* of the past couple years, roughly 94% of all incumbents were surprisingly reelected. Generally, the only ones who were not returned were a few very extreme on the right and some far out to the left, which unleashed the “Fiscal Cliff” drama that the media relished throughout the holidays. If you recall later in that note, my *hopeful* prediction was that because this wasn’t truly a “lame duck” session in the traditional sense, since most of these folks are right back in their chairs as the 113th Congress began, they would at least make an attempt to do their jobs in line with everyone’s expectations and their sworn duty. Ha! A not-so-subtle reminder that an old Wall Street saw has been proven once again: *Hope is not a strategy*.

However, I will take full marks for outlining the endgame that our current dysfunctional group of selfish *leaders* would employ, which also held true once again. To reiterate: the current crop of American and European politicians will take no action until Cinderella’s carriage is on the verge of turning into a pumpkin. But once presented with said squash, they will do what is necessary to salvage what they can, (even though they rarely seem to know the specifics of any of these deals) move forward and point the finger of blame across the aisle.

This, in my humble opinion, is why the markets have continued to chug forward in the face of Washington’s ineptitude - simply because they are not yet dangerous. We seem to be heading in that direction (I’m sure I saw security cam video of Nero carrying his violin case off the escalator at the Smithsonian Metro stop) but we’re not there yet. Just wait until the debt ceiling debate fires up again over the next couple of months… And of course in typical Beltway fashion, they are ringing in the New Year with very little time actually spent working in Washington over the next couple of months, so when they are in-house the rhetoric will certainly be fiery and completely hyperbolic. The 24-hour news folks on TV and radio will think it’s Christmas all over again.

Now, off the politics for a bit… Although we now appear to be entering our 3rd or 4th year where government is the primary, short-term emotional driver of the financial markets, the longer-term economic trends are likely more important. One thing that not many seem to notice in the face of all that political noise, at least based on my discussions, is that the markets appeared to digest all the emotional news fairly well in the 4th quarter with the S&P showing only a modest drop, but most of our portfolios flat to slightly positive for the quarter. Thus capping off what turned out to be a pretty good year overall, directly in the face of all the political nonsense and general fear mongering. As the Brits would say, “Chin up, old boy – keep calm and carry on.”

Thinking then about the future implications, was the deal passed at the very last minute perfect? Not even close, but I'm not sure what all the horrible complaining from both sides has been about to tell you the truth. (Other than pure political grandstanding…) It seems to me that the only thing that the GOP gave up was a marginal tax rate increase on income earners well into the top 1% – the new *Affordable Care Act* kicking in this year will be far more costly to the economy than that. Both sides can catch a little blame for allowing the 2% Social Security wage tax cut to expire (which was never supposed to be anything but temporary) raising taxes on everyone who has a job or runs a small business. (**cough**)

However, the Republicans were also able to get all the rest of the current income tax brackets locked in permanently (i.e.no future sunset date like the Bush cuts) and cement the estate tax exemption threshold at $5 million. I'd call that a very big win.

Even better, you can now use the entire exemption amount for gifting purposes, whereas in the past that had not moved past $1 million even as the estate exemption continued to rise. A married couple now, with proper planning, can leave $10 million to their families with no federal taxes due. Seems fair to me and *should* end a lot of the complaining about the "death tax" during future discussions. We'll see…

So, with both sides seemingly feeling bad about the deal they were "forced" into passing at the 11th hour (a situation completely manufactured by their spineless ineptitude in 2011) I'm sure the coming debt ceiling debate will be every bit as rancorous as the one that generated the "Fiscal Cliff" in the first place. I'm also sure there will be tremendous market volatility and dislocations in the short term, however the difference this time, even with all those in the screaming media already manning the bellows to fan the flames, is that more and more people believe there will be a deal right at the end. Because again, that's what they do in the current leadership vacuum…

As for the general economy that continues to plod along, the Federal Reserve has remained steadfast in their message that they intend to keep rates low as far as the eye can see. I'm sure there will be some rebellion in the bond markets, some of which we're already seeing, and in fact some changes will be coming to our portfolios over the next few weeks as we rebalance. But let's all remember that rates remain at historically low levels - a hard fact that continues to be a positive for corporate earnings as well as income paying stocks. (Another apparent "win" contained in the recent tax bill is the fact that taxes remain the same on capital gains and dividends for all those below the new highest threshold.)

And now for something completely different… Earlier this week I was fortunate enough to attend the first of a series of classes offered by our church. Now for those of you who don't know me as well, I go to a fairly unusual church… The church itself is a regular Episcopal Church, however it is populated by a pretty interesting and well educated group, not the least of which is the gentleman who is teaching our class on Quantum Mechanics and why the discovery / proof of the Higgs Boson is important. (We also had a very interesting class back in October discussing Emily Dickinson's poetry, taught by a parishioner who is a former English department head at UCLA.) As my southern friends would say, "High cotton" for sure…

The first evening of our physics class contained a bunch of crazy looking equations and a good deal of history outlining the somewhat recent (relatively speaking) transition of the science. What caught my attention and seemed relatable to what I do is a theoretical leap that the physics community made back in the early 20th century.

Basically, prior to this evolution in outlook, physics was like most other scientific endeavors in that it was results based – i.e. everything was reduced to its minimalist format looking for concrete answers. As the thinking expanded, physicists realized that what they were really trying to figure out was what was *knowable.* That was a big deal, because it opened the doors to the idea that there are things that are *unknowable* and that is okay - in fact the practical application of the science may be more grand by this change in thinking. (Think, Stephen Hawking to Star Trek – just because we're not sure how something may work, doesn't mean we can't imagine the possibilities and put them in play.)

The basic idea the theory put forth is that before you make an observation and take a measurement it's completely impossible to tell what occurs before that moment, because the act of measuring changes the course of everything in a completely random pattern. And how I believe that relates to investing, politics, the overall economy and other events that drive what we do is that it reminds you to focus on what is knowable and how those variables may react when they come into contact with outside stimulus.

It also makes me wonder if our old friends Graham and Dodd, fathers of modern securities analysis, hobnobbed with physicists. Both believed that with proper application of your analysis probable success would occur in the long-term. However, the short-term noise mixes in the unknowable portion of our task. Especially in our era of information on demand with the screaming media pushing it towards everyone constantly – human emotions and current politics makes for a frothy brew in the markets.

As for our planned way forward in 2013, we do intend to continue to reduce pooled fixed income allocations, although none are very long in duration currently. And also continue to monitor the political nonsense both here and across the pond. There will be some big emotional battles coming for sure, and we will keep hoping for reason and maturity to prevail. (Although as mentioned at the beginning of this piece, we're not holding our breath nor is this our *strategy* :)

Thank you as always for your continued trust and confidence. Here's to a great year ahead for all of us and for the country as a whole. Cheers!