The dog didn’t bark!1

The "curious incident of the dog in the night-time" is easily explained: the dog made no noise, because no stranger was there. As Holmes explains: “I had grasped the significance of the silence of the dog, for one true inference invariably suggests others...”

Why has the economy slowed, again? You need not be Sherlock Holmes to answer the question. And I dismiss out of hand the assertion that “the weather” is to blame. How Pathetic! Only reinforces, what we already knew, the economy has gone from unremitting industrial might to feeble, needing some luck from Mother Nature. Climate change study and actions cannot buy that luck. Despite the new dependence on the “fates”, this vulnerability is rapidly increasing: solar and wind power are at the mercy of the weather as well.

Economic expansion is far below the “trend line growth” rate of the 3.5%. The output gap remains large. The long term unemployed are. The labor participation rate is awful: bad for the economy and a tragedy for those “retired” against their intentions. The US equity markets have surprised; growth has faltered, and utilities are in.

The expansion in the earnings side of the equation has stalled. The optimism about future economic growth underlying the expansion of the P.E. multiple has waned, as have prices. Reality intrudes; the idea that the economy is doomed to a period of sub optimal growth diminishing the prospects of future generations percolates and becomes resonant.

How can an investor position for this uncertainly? The charts are anomalous in the near term. Amazingly, and for unknowable reasons, the US equity markets are in a long term secular bull market. Short and intermediate trends do not seem so benign.

Focus and patience, along with confidence in the long term trends remain crucial at these junctures. One group falls off a cliff and others, perhaps less glamorous, rotate into favor. These movements create opportunity as well as peril, A Magical Mystery Tour.2

So, I’m reading a quarterly report, and get to the bottom line, an effective tax rate of 41%. My first thought, why don’t they pick up and leave, or engage in “Caterpillar”3 or potential “Pfizer”4 avoidance of some sort.

After corporate income tax rate 30- 40%, if some of the net profits are “returned to an investor”, it is likely taxed again, at 20%-25%. And the USA is the only developed country to utilize a unitary tax system, basically taxing all income at USA rates, regardless of where it is earned. In my opinion, repatriating those earnings is a waste of corporate assets if the board can insulate their US shareholders from higher taxes.

1 http://en.wikipedia.org/wiki/Silver_Blaze
2 http://www.youtube.com/watch?v=Hnrsqf33MXA The song is credited to Lennon–McCartney, though written primarily by Paul McCartney. McCartney said it was co-written.[2] John Lennon said, "Paul's song. Maybe I did part of it, but it was his concept."[3] In 1972, Lennon said, "Paul wrote it. I helped with some of the lyric. http://en.wikipedia.org/wiki/Magical_Mystery_Tour_(song) 
The tax inversion strategy is the best idea de jour. The current tax regime also favors stock buybacks, or even the ultimate buyback, a Leveraged Buy Out (LBO). Only a policy maker would think that tax payers’ behavior will remain static in the face of rates that are perceived as punitive and confiscatory.

There is no mystery why the economy is functioning poorly, substantially weaker by nearly every measure of a “recovery”. Nor is there any mystery why the various investment markets have generally fared very well.

Let’s all acknowledge that Keynesian economics has worked spectacularly well achieving its stated purpose: increasing the value of monetary assets, thereby inflating the price of investments in world stock markets, real estate, collectibles, etc. That some stocks are priced beyond any reasonable long term valuation as a result of the “stimulus” suggests the beginnings of an investment “bubble.”

Yet, I am not surprised that the “success” of the Neo Keynesian policy has failed to deliver the expected economic boost. The benefits have largely remained economic phenomena. The tide is still at ebb, grounding many boats.

Despite the compelling evidence of the impotence of this approach, the members of the current economic directorate, The President, Department of the Treasury, and the Federal Reserve Board, remain on the same page – more of the same.

The definition of insanity, doing the same thing over and over and expecting a different outcome, suggests the disturbing diagnosis, a consensus of dementia. And given the recently announced change in mortgage policy, they also suffer from amnesia.

Reality might be allowed to intrude if the policy makers were not as prejudiced by ideology. Eventually that reality will become manifest. Unfortunately, this may only occur under the duress of another crisis.

The causes of the tepid economic growth are obvious:

Economic:

1. High and complex taxes,
2. Invasive and punitive regulation, driven by ideology, and some transparent cronyism, and
3. UNCERTAINTY about the rule of law, kind of like Russia, no one can know what the Imperial government is going to decree, change, or when they will simply ignore the law.

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5 A bubble is a “trading phenomena”. Once the existence is discerned, long term investors should be concerned, speculators delighted. Sometimes the sector bubbles deflate rapidly, to a more realistic valuation. During these bursts, on occasion, unique companies with wide moats become temporarily undervalued.

6 Demand-Side Policy Gave Us the Big Economic Fizzle. The unstimulating stimulus ignored basic principles of economic incentives. http://online.wsj.com/news/articles/SB10001424052702304418404579467141423574578

Psychological:

1. There is a wide spread perception that our Government is hostile to private business;
2. That it views high earners as an endless source of tax revenues, and
3. Despises wealth, unless the President is fundraising among the select 1/10 of the 1% he deems acceptable.
4. At the same time many feel that the government is incompetent, often wasteful and
5. Rife with corruption on all levels. The “vampire pensions” facing many states and localities, are a prima facie case of the collusion of a government negotiating with itself, the public employee unions that “run” the bureaucracy.
6. These concerns only intensify, when there is a massive invasion of personal privacy, every call, every e-mail, and back doors to computers. And now drones?

The traditional balance of power within our society and the economy has changed. The Executive branch has succeeded in gaining the upper hand in the competition with traditional forms of social organization: business, the family, education, and even religion. It can unilaterally impose onerous regulations and direct the punitive weight of the police state against “enemies” in the guise of various law enforcement agencies. The President has famously stated that he has a “Pen and a telephone” to unilaterally make “law”. In my opinion, he also had a direct line into the IRS director, the National Taxpayers Employees Union Leadership, and other government agencies as well. The persecution of “True the Vote” is right out of Kafka.8

By definition, the initiation of a “police state” occurs when nominally civilian agencies, such as the IRS, BLM, EPA and others become armed law enforcement organizations, fielding heavily armed swat teams.

There are many reasons, substantive and psychological, that make opening or growing a business in the USA unattractive.

So forget about trend line growth. Worry about the failure to address the true issues of our economy, as opposed to those seeking to impose remedies that have repeatedly failed.

The domestic challenge remains: financing the retirement of the baby boomers as the demographics of the USA inevitably change. That problem becomes increasing acute the longer it is avoided. It is intensified by the continued gross underemployment of the population. By now it should be conventional wisdom that the official rate in the mid 6% range is merely one reading, and there are other BLS employment statistics are more reflective of “true unemployment”. These sober statistics remain stubbornly lodged in double digits five years into what might have been a “trend line” recovery. Yet the gap remains wide and there appears to be little chance of catching up to, or surpassing the magic 3.5% rate of GDP growth.9

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http://oversight.house.gov/hearing/irs-targeting-investigation-administration/#

9 The GDP report suggested the economy grew at a 0.1 percent annual pace in the first three months of the year, but data released since then on trade, construction spending and factory inventories has led economists to expect an update on GDP later this month to show a contraction.
http://www.reuters.com/article/2014/05/09/us-wholesale-inventories-idUSBREA480HM20140509
There are multiple solutions. Apparently, current policy is to let the markets call the tune, blissfully unaware that the markets are fickle and can change like the weather. While markets may be fickle and can change, these ultimately reflect the underlying economic conditions. Pause for a moment and consider the stated goal of policy makers:

“INCREASE THE INFLATION RATE!”

Memories are short. The US has never been able to put the inflation genie back in the bottle without great economic pain. The recent rise in the price of nearly everything, but especially energy, food and housing\(^{10}\) seems to be studiously ignored. It would seem that our policy elite are immune to these price pressures, it matters little what a jet flight and private hotel floor costs. How many of the members of the Federal Reserve Board of Govenors worry about the cost of filling a gas tank, an energy bill, the cost of fresh food, or college tuition on a personal level?

The challenges mount. The Country needs leadership. Consider these statements:

“Ask not what your country can do for you, ask what you can do for your country.” - John F. Kennedy, inauguration address, January 20, 1961.

Or the following from Franklin D. Roosevelt's First Inaugural Address (1933) “So, first of all, let me assert my firm belief that the only thing we have to fear is fear itself - nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance. In every dark hour of our national life a leadership of frankness and vigor has met with that understanding and support of the people themselves which is essential to victory. I am convinced that you will again give that support to leadership in these critical days.”

Or more recently:

“Watching the Olympic Games last summer, Nancy and I were thrilled, as I'm sure you were when we heard those repeated chants of U.S.A.! U.S.A.! Did it occur to you, as it did to us, that while each of those words - United States of America - is important, none is more so than the first. Yes, we are united. That is our rich heritage. There were moments in recent years when we wondered if we were still united, but not today. Crisscrossing this land these last few months, I have seen such proof of national unity I know our children will inherit an America that's united and coming together again.

There's more than the freshness of youth on those faces I've seen; there is the future and hope of all America. Tomorrow is theirs, a time when they can fly as high as their talents will take them. It's up to us to pass on to them a nation that's free in a world at peace…

\(^{10}\) The 0.6% U.S. April PPI rise with a 0.5% core price increase blew past assumptions thanks to widespread gains that left 0.6% increases for both the goods and services components, with a particularly large 1.4% rise for trade services that doubled-down on the 1.4% March increase. We also saw a big 2.7% drought-led surge in food prices, alongside a restrained 0.1% rise for energy.
Read more: [http://www.nasdaq.com/article/us-economics-april-ppi-wrap-cm353028/#ixzz31hf6ZB8g](http://www.nasdaq.com/article/us-economics-april-ppi-wrap-cm353028/#ixzz31hf6ZB8g)
America is coming together again. We're building together. But what I'm really thankful for is that all across this shining land, we're hoping together. We can say to the world and pledge to our children: America's best days lie ahead. And you ain't seen nothin' yet.

“Thank you, good night, and God bless you.”¹¹

Now please consider and compare President Obama’s “performance” on “Between the Ferns” shilling for his healthcare plan at the cost of personal mockery. It is unnecessary to quote anything; this coarse and vapid interview that diminishes the office of the President, forever, speaks for itself.¹²

Fortunately, the US economy is ultimately more powerful and durable than any Administration. Despite repeated policy failure, the recovery plods along. The current recovery is a testament to the fundamental strength of the “common” people, doing the best they can. Perhaps the mid-term elections will deliver a political coup d’état and the deficit reducing stasis will continue? A “deflowered” President Clinton was unable to spend the increased revenues he gained in his pre-Monica power phase. Perhaps, this President will find himself in the same hapless position, balancing the budget and presiding over a slowing economy, ushering the next Republican president.¹³

This might produce a “goldilocks” domestic scenario. Unfortunately, international conflict threatens to upset the apple cart.

There are obvious implications from the rising tensions and resumption of war in Europe. I’d be surprised if economic production from the regions affected is not seriously impacted. There could be shortages of wheat, oil, natural gas, potash, as well as the fallout from reduction in the cross border trade between the Euro Zone and Russia.

Strong stocks in strong trends at the right price is the equity strategy of choice in a secular bull market. On the income side, the 30 year Treasury price chart has turned intermediate trend bullish. If the “breakout” persists, the opportunities in the interest sensitive stocks expand. The reasons for lower interest rates, if this comes to pass, are probably not favorable for equities.

One should expect top line contraction across a wide swath of businesses if interest rates fall because of a slowdown, or worse a modest growth recession.

I want to return to one of the issues from Don’t Stop Thinking about tomorrow, Amazon (AMZN, $297.10, 05/19/2014). Amazon has continued to reinvest and reinvent their business at almost unprecedented rates. It is one of the very few shares that warrant a high current PE ratio, in my opinion. It poses a competitive threat to many other businesses, e.g. Netflix (NFLX, 365.01, 05/19/2014), and should soon bring “Kindle” like price competition to the “smart phone”

¹² http://www.huffingtonpost.com/2014/03/14/obama-between-two-ferns_n_4966292.html
¹³ Magic Bus” is a song written by Pete Townshend during the time that My Generation was being recorded in 1965. http://www.youtube.com/watch?v=bh9bvuAY-Aq
market. And, it seems to me that the current price is attractive to raiders and corporate activists. Sometimes the best\footnote{Amazon.com Inc. (NASDAQ: AMZN) is considered the most reputable company in the world, according to Harris Interactive. Read more: Companies With the Best (and Worst) Reputations - 24/7 Wall St. \url{http://247wallst.com/special-report/2013/02/15/companies-with-the-best-and-worst-reputations/#ixzz30BiSrBbc}} is expensive, but it is worth paying up.

Bonds have rallied strongly, a small top pattern completed in the equity market, the US Dollar is teetering on support, gold’s luster has dimmed, temporarily, in my opinion, and crude oil continues in a sloppy uptrend, Natural gas is another story; it now appears that the bottom is in for several reasons. If, because of a mild summer cooling season, natural gas retreats toward $3.25-3.50 again, that would be a backup the truck moment in my vernacular. The emerging markets have strengthened, particularly Brazil. How are we to mock another economy with our feeble GDP of 1/10 of one percent (at best) from the last quarter? Yet there is no breakout. Europe seems to only to ooze higher, grounded by the Russo-Ukraine conflict.

Various asset classes and sectors within those asset classes are suggestive of investment decisions.

Please consider the following charts.

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International investing involves additional risks such as currency fluctuations, differing financial and accounting standards, and possible political and economic instability. Also, investing in emerging markets can be riskier than investing in well-established foreign markets. There is no assurance any of the trends mentioned will continue in the future. Investing involves risk and investors may incur a profit or a loss, including the loss of all principal.

Companies engaged in business related to a specific sector are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Gross Domestic Product (GDP) is the annual market value of all goods and services produced domestically by the US.

U.S. Treasury securities are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and guaranteed principal value.


Price Earnings Ratio (P/E) is the price of the stock divided by its earnings per share.

Commodities are volatile investments and should only form a small part of a diversified portfolio. There may be sharp price fluctuations even during periods when prices overall are rising.

The Bovespa Index is a total return index (includes the effect of dividends) and is generally considered the main indicator of the Brazilian stock market's average performance. The index is comprised of the most liquid stocks traded on the Sao Paulo Stock Exchange.

The MSCI is an index of stocks compiled by Morgan Stanley Capital International. The index consists of more than 1,000 companies in 21 developed markets.

The S&P 500 is an unmanaged index of 500 widely held stocks that’s generally considered representative of the U.S. stock market. The S&P 500® Equal Weight Index (EWI) is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight.

It is not possible to invest directly in an index.

The Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four different local currency markets. This multi-currency benchmark includes fixed-rate treasury, government-related, corporate and securitized bonds from both developed and emerging markets issuers.

Raymond James & Associates, Inc., Member New York Stock Exchange/SIPC
3.7 S&P 500 Equal Weighted Index ($SPXEW) 3

3.8 US Dollar Index (Cash Settle (EOD)) ($USD)

3.9 GLD-Default Style