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Capitalism's Collision Course

The national election is now just a few weeks away. In our last edition, we stated that the outcome of the election is likely to take the domestic economy in two distinctively different directions, and as investors we should view this period with great caution.

We think capitalism is on a collision course. If the status quo remains, we believe investment markets should not return to historical norms until investors have reason to believe that the economy can grow at more robust and sustainable levels.

We think the way to discuss the economic status quo is to define our key terms. First, the word capitalism itself. We have already defined capitalism for longtime readers. Please see enclosure number #1 of our April 2012 edition titled "Can We Agree On What Capitalism Is" which is also available on our website.

While the political debate is white hot there is economic inertia already in place. Let's call this economic inertia "Literalville" and the political debate "Fantasyland". The political debate is so called because politicians on both sides of the aisle often lose focus on reality and preach ideas that can only be rooted in fantasy.

Literalville represents the reality of what is coming at us just by the clock continuing to run. There are many economic issues that will arrive at our doorsteps in the next 5-10 years. We will discuss what we believe are the largest and potentially most dangerous.

Government at every level has made promises of future benefits that are so large, that they likely cannot really be paid. Estimates have been so large that listing the numbers would be futile. There would be too many zeros to understand. There isn't enough financial capacity in the world to pay all benefits promised.

Long term unemployment and its long term affect on future growth is another concern. Innovation requires higher skills. Long term unemployment freezes many out of new opportunities for their lifetime.

No matter how much we tax, we are borrowing $.40 of every dollar spent. Currently, no policy is in place to change this.

We think current tax policy is arcane and chaotic. The tax code itself has become a significant burden to Capitalism's "animal spirits." The tax changes that, by current statute, occur after January 1, 2013 are likely to make entrepreneurial risk taking even more difficult.

The potential negative effects of this collision course could continue the toxic investment environment of that the last few years. The current 10 year return from the benchmark Standard and Poor's 500 Stock Index (S&P 500) is well below the level of returns from markets with higher growth economies. Investors have been patient with their financial plans, however future returns need to be significantly higher than those of the last decade for these plans to succeed.

We do believe that Capitalism's Collision Course will be difficult to avoid and its effects difficult to endure. We have managed client assets during similar storms over our 35+ years at the helm and are confident we can continue to do so.

What we're curious about is the popular idea that the collision course is unavoidable. Certainly there will be consequences for our collective fiscal orgies. Yet we believe there are potential solutions that can give investors more hope than the financial media may understand.

We believe that the best near term solution is to seed what Capitalism would call a Wealth Creation Wave (WCW). This topic is discussed in length in Enclosure #2 titled "A Wealth Creation Wave."

IN SUMMARY: While the polarized political debate will decide the next president on November 6th, the inertia of the financial status quo is building. In simple terms, the worst path for investors is the status quo. If our aim is to see the economy revitalized and markets returning to trend, we must seek solutions to these problems that are based in economic ideologies that have worked to bring the nation from recession to expansion.

What Do We Expect Ahead?

In a word resolution! Yes, who will be elected president next month will resolve some political issues. However, in our view, the choice between President Obama and Governor Romney is also a choice of economic ideology. Very few presidential elections in our time have offered such a contrasting choice.

A 20th Century economic theory, known as Keynesian or Demand Side Economics urges the federal government to increase its spending during economic downturns. Over the last 50 years or so, this theory has made government a much bigger participant in the total economy than in the past. Think of federal, state and local governments as the public sector economy. In many ways, it competes for capital and talent with the private sector economy.

The other, less popular, economic theory, developed in the late 19th Century is known as Classical Austrian Economics, or Supply Side Economics. This theory differs from Keynesian thinking in that its emphasis is on incentivizing the supply, or production, side of the economy to re-invest in itself. The economy grows when private entities re-invest in their businesses.

The two candidates for president are close proxies for their respective economic ideologies:

President Obama believes in the expansion of the public sector economy. As a career member of the public sector economy, he should understand the public economy better than the private economy and looks to the public sector for answers.

Governor Romney believes in the expansion of the private sector economy. He has a great understanding of the private economy, and is calibrated to think solutions are best sought through the private sector.

With such a sharp contrast offered in this year's election, we opined in our last edition that the winner may finally breakup the stock market stalemate of the last five years or so. Investors have been frustrated by stock prices that have been high in volatility yet low in net returns.

PORTFOLIOS

Portfolios we manage by discretion have had a busy year. Last April we saw the need to reduce risks in our portfolios. With the presidential election six months away combined with the usual suspects, the Euro Crisis and a slowing domestic economy, we were concerned that the markets in the summer of 2012 looked more like a field of land mines rather than a pasture of opportunity.

We implemented what we call the Life Boat Drill. We reduced our collective risk exposure to stocks in general and used short term bonds and cash to replace capital appreciation and emerging markets positions.

In our last edition, we characterized this action as being camped at a fork in the river. We had confidence the stock market has an excellent history of forecasting changes in economic direction. Don't forget, markets are not trading on today's news; rather they are focused on the economy and the potential for rising earnings six to nine months from now. As such, we believe the market is beginning to send a message that economic conditions could be improving into the Spring of 2013.

Accordingly, we have begun to take on new positions in capital appreciation stocks. We can't jump up and down with excitement yet, but we have gotten through the last six months without stepping on any land mines! We think the risks of owning suitable equities have returned to a more normal level.

Where we see opportunity developing in equities, we see the exact opposite in bonds. We think long term bonds may be the worst investment vehicle to purchase at this time.

Interest rates have been declining for 30 years. If the domestic economy is to return to historical growth rates, so should interest rates in general. As interest rates rise, the prices of bonds decline. Worse, locking in today's rates for 10-20 years also locks one into much lower cash flow from bonds than may be offered in just a few years.

In portfolios we manage by discretion, we have over weighted holdings in energy MLPs and REITs in an attempt to keep cash flows at high levels without taking what we perceive to be rising risk.

In Summary: The environment for investing over the last few years is best described as going violently nowhere. With the election finally in its final leg, we are confident markets may stay more violent than calm, but we see them actually going "somewhere" finally.

ENCLOSURES

Enclosure #1 is an essay by ABC News Analyst and syndicated columnist George Will. He thinks the root of the modern "doom and gloom" theories date back to an MIT study in 1972. At that time, a well intended computer model predicted a dire future because of limited supplies of basic commodities. The study led to the book "The Limits of Growth." It sold 12 million copies!

Enclosure #2 is entitled "How to Start a Wealth Creation Wave." This commentary described much of the financial carnage of the last five years as a Wealth Destruction Wave. We believe the best way to revitalize the domestic economy is to seed a new Wealth Creation Wave.

Enclosure#3 is a short explanation of the different measurements of unemployment provided by the Bureau of Labor Statistics. Often, important information is lost when relying solely on media reports.

Important Disclosures

This report is not intended as a complete description of the securities, markets or developments referred to herein. It should not be viewed as an offer to buy or sell any of the securities mentioned. Information has been obtained from sources considered reliable, but we do not guarantee that the foregoing report is accurate and complete. Additional information and sources are available upon request.

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Commodities and other alternative investments are generally considered speculative, volatile investments. When appropriate, they should only form a small part of a diversified portfolio.

Fixed income securities are subject to risks including interest rate, inflation, credit and market risks. If sold prior to maturity, an investor will receive the current market value, which may be more or less than the original investment.

The S & P 500 is an unmanaged index of 500 widely held stocks generally considered representative of the US equity market. It is not possible to invest directly in an index.

Investments in the energy sector are not suitable for all investors. Further information regarding these investments is available from your financial advisor.

Alternative investment strategies involve greater risks and are only appropriate for the most sophisticated, knowledgeable and wealthiest of investors.

MLP distributions are not guaranteed. The actual amount of cash distributions may fluctuate and will depend on the future operating performance. Increasing interest rates could have an adverse effect on MLP unit prices as alternative yields become more attractive.

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REITs are financial vehicles that pool investors' capital to purchase or finance real estate. REITs involve risks such as refinancing, economic conditions in the real estate industry, changes in property values and dependency on real estate management.

International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

The Weiss Report
Volume 15, Number 4
Enclosure 1

Calls For Doomsday Remain Unheeded

By: George Will

Sometimes the news is that something was not newsworthy. The United Nation's Rio+20 conference — 50,000 participants from 188 nations — occurred in June, without consequences. A generation has passed since the 1992 Earth Summit in Rio, which begat other conferences and protocols (e.g., Kyoto). And, by now, apocalypse fatigue — boredom from being repeatedly told the end is nigh.

This began two generations ago, in 1972, when we were warned (by computer models developed at MIT) that we were doomed. We were supposed to be pretty much extinct by now, or at least miserable. We are neither. So, what when wrong?

That year begat "The Limits to Growth," a book from the Club of Rome, which called itself "a project on the predicament of mankind." It sold 12 million copies, staggered The New York Times ("one of the most important documents of our age") and argued that economic growth was doomed by intractable scarcities. Bjorn Lomborg, the Danish academic and "skeptical environmentalist," writing in Foreign Affairs, says it "helped send the world down a path of worrying obsessively about misguided remedies for minor problems while ignoring much greater concerns," such as poverty, which only economic growth can ameliorate.

MIT's models foresaw the collapse of civilization because of "nonrenewable resource depletion" and population growth. "In an age more innocent of and reverential toward computers," Lomborg writes, "the reams of cool printouts gave the book's argument an air of scientific authority and inevitability" that "seemed to banish any possibility of disagreement." Then — as now, regarding climate change — respect for science was said to require reverential suspension of skepticism about scientific hypotheses. Time magazine's story about "The Limits to Growth" exemplified the media's frisson of hysteria:

"The furnaces of Pittsburgh are cold; the assembly lines of Detroit are still. In Los Angeles, a few gaunt survivors of a plague desperately till freeway center strips ... Fantastic? No, only grim inevitability if society continues its present dedication to growth and 'progress.'"

The modelers examined 19 commodities and said 12 would be gone long before now — aluminum, copper, gold, lead, mercury, molybdenum, natural gas, oil, silver, tin, tungsten and zinc. Lomborg says:

Technological innovations have replaced mercury in batteries, dental fillings and thermometers, mercury consumption is down 98 percent and its price was down 90 percent by 2000. Since 1970, when gold reserves were estimated at 10,980 tons, 81,410 tons have been mined and estimated reserves are 51,000 tons. Since 1970, when known reserves of copper were 280 million tons, about 400 million tons have been produced globally and reserves are estimated at almost 700 million tons. Aluminum consumption has increased 16-fold since 1950, the world has consumed four times the 1950 known reserves, and known reserves could sustain current consumption for 177 years. Potential U.S. gas resources have doubled in the last six years. And so on.

The modelers missed something — human ingenuity in discovering, extracting and innovating. Which did not just appear after 1972.

Aluminum, Lomborg writes, is one of earth's most common metals. But until the 1886 invention of the Hall-Heroult process, it was so difficult and expensive to extract that "Napoleon III had bars of aluminum exhibited alongside the French crown jewels, and he gave his honored guests aluminum forks and spoons while lesser visitors had to make do with gold utensils."

Forty years after "The Limits to Growth" imparted momentum to environmentalism, that impulse now is often reduced to children indoctrinated to "reduce, reuse, and recycle." Lomborg calls recycling "a feel-good gesture that provides little environmental benefit at a significant cost." He says "we pay tribute to the pagan god of token environmentalism by spending countless hours sorting, storing and collecting used paper, which, when combined with government subsidies, yields slightly lower-quality paper in order to secure a resource" — forests — "that was never threatened in the first place."

In 1980, economist Julian Simon made a wager in the form of a complex futures contract. He bet Paul Ehrlich (whose 1968 book "The Population Bomb" predicted "hundreds of millions of people" would starve to death in the 1970s as population growth swamped agricultural production) that by 1990 the price of any five commodities Ehrlich and his advisers picked would be lower than in 1980. Ehrlich's group picked five metals. All were cheaper in 1990.

The bet cost Ehrlich $576.07. But that year he was awarded a $345,000 MacArthur Foundation "genius" grant and half of the $240,000 Crafoord Prize for ecological virtue. One of Ehrlich's advisers, John Holdren, is President Barack Obama's science adviser.

The Weiss Report
Volume 15, Number 4
Enclosure 2

A Path to a Wealth Creation Wave

By: Leonard A. Weiss

The private economy has been hijacked. By private economy, we refer to one that fits the dictionary definition of Capitalism. The economy we speak of has been hijacked by politics. Over the past few decades, government fiscal policy has warped the private economy. We will attempt to answer the question; what will it take to get the economy growing again? We believe the answer is a new wealth creation wave. This leads to the next question, how does a wealth creation wave get started?

The best place to look for answers to these questions is found in economic history, most specifically in the results of fiscal policy enacted by the government. Policies that resulted in tax decreases and a positive business environment were central to the fiscal policy of Presidents Bush 43, Reagan, and even John F. Kennedy. Political posturing aside, pro-growth policies have been at the center of all answers to this question for 50 years. Tax cuts and similar incentives have worked every time they were implemented. Tax cuts and/or tax reforms have ignited wealth creation waves regardless of the political party that implemented them.

After the tax cuts of 2002 and 2003 by Bush 43, which were enacted after the recession brought on by the dot.com crash, we noticed many significant outcomes. First, government revenues driven by investment taxes increased. Within four years, the unemployment rate fell below 5%. The overall economic environment was positive for business.

In the late 1970s, the economy was also under similar stress levels. The stressors then came from different areas than today; however that level of stress produced a double dip recession. The top income tax rate at the time was 70%. In 1981, 1982, and 1986, major tax cuts and reforms were enacted.

The cuts were put in place after years of economic stagnation and two recessions. The stock market had been virtually unchanged in 10 years. Unemployment peaked over 10% in 1981, dropping to under 6% by the end of the decade. As a result of the tax cuts and pro growth policies, GDP growth averaged more than 6% between 1983 and 1986 while revenues to the federal government more than doubled between 1982 and 1989.

But much of the above is known by most investors. However it is the actions of John F. Kennedy in 1962 that are not as well known or understood. Kennedy, in an effort to grow government revenues took many decisive steps:

- In 1961, Kennedy was told by West German Chancellor Erhard to avoid the British model of high taxes which had all but killed economic growth in England
- Kennedy then said to the Economic Club of New York that ..."an economy hampered by restrictive tax rates will never produce enough jobs or enough profits"
- He proposed a two year tax cut across the board
    - The 91% top rate would move to 70%
    - The minimum rate would move from 20% to 14%
- Over the next six years, the economy grew
    - Personal savings rose from 2% to 9% per year
    - Business investment rose from 2% to 8%
    - GDP rose 40%
    - Job growth doubled
    - Unemployment fell by a 1/3rd

The above facts and details can be found in "A Patriot's History of the United States" by Dr. Lawrence Schweikart and Dr. Michael Allen. Reading this book will provide significantly more detail on the economics of the time. The authors go to great lengths to find data collected in their time, not recycled data to fit any political ideology.

Between 1960-1962, tax revenues were sluggish prior to the JFK tax cuts. However after the cuts, revenues increased dramatically.

1960: $92.4 Billion	1964: $112.6 Billion
1961: $94.4 Billion	1965: $116.8 Billion
1962: $99.7 Billion	1966: $130.8 Billion
1963: $106.6 Billion	1967: $148.0 Billion

*All data from the National Taxpayers Union

We have detailed what happened 50 years ago to stress that economic policy can act like an accelerant or a dampener to economic growth. The history of what works and what does not is judged by rising and falling GDP growth rates over the years.

Much has been said in the political arena about what type of economic policies should be enacted. We are strident in our belief that the primary cause that created the stalled economy of 2012 is bad economic policy. The primary deficiency of current fiscal policy is that it never intended to spark a new Wealth Creation Wave.

George Schultz, now 91, was interviewed in the Wall Street Journal on July 14th, 2012. Schultz was a cabinet secretary under three presidents. He ran the largest privately held construction company, Bechtel, in the late 1970s. He spoke about the toxic environment for risk taking of the problem in football terms:

"What owner would invest in a team, and field players, when you can't know all the rules when the game begins? What owner would field a team if he/she didn't know if there was an impartial referee; and what owner would field a team for a game whose rules can be changed at halftime?"

Schultz went on to say that business just needs a window of cost certainty for the next five years or so. Current economic policy has created no such window. There is uncertainty in tax rates, costs of employment and statutes passed in 2010 have incomplete regulations. All of this seems to fit into Mr. Schultz's football analogy.

In summary, we believe that the answer to the question of how to re-ignite the economy is simple: spark a wealth creation wave. First, we need to do what has worked every time it's been tried. We must enact economic policies that allow more capital and decision making certainty to move back to risk takers. This is the path to such a wave.

The Weiss Report
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Enclosure 3

Is There Really A Decline In Unemployment?

By: Leonard A. Weiss

As information filters for our clients, we take the responsibility to stay well informed on economic data and trends. We do this in hopes that we can sort out accurate and valuable information and pass it on.

It is because of this role that we are scratching our heads over the recently reported statistical decline in unemployment. Many of the economic metrics we study find the economy stalled at best and decelerating at worst. Through this lens, we'd expect to see unemployment as stagnant as it has been for the last three years.

The definition and measurement of unemployment is at the heart of the disconnect. On the first Friday of each month, the Bureau of Labor Statistics (BLS) releases the unemployment rate trumpeted by the media. This measurement is called the "U3 Rate." It is comprised of people that say they are working full time plus the people that can be counted by unemployment benefits.

But what about those who have lost benefits and have dropped out of the count? What about those who say they are working, but part time and seek full time employment?

The BLS does calculate a measurement for such situations. It is called the "U6 Rate," and is listed on the same page as the nominal U3 rate. Since the U6 calculation includes those who have stopped looking for work and those who work part time and can't find better circumstances, we believe U6 is a better measure of true unemployment.

We have included Table A-15 from the September 7th, 2012 report. It shows that the media reported U3 rate dropped to 8.1% and the U6 rate dropped to 14.7%!

This rate has been in the mid-teens for several years now. In December 2009, the BLS calculated U6 at 17.3%. While in December of 2010, it was calculated at 16.7%.

We believe that the real unemployment rate has fallen very little since late 2009 despite all the Quantitative Easings. From this definition of unemployment, it is easier to see why the economic growth rate is so anemic. This is why investors should be very concerned that we are getting accurate readings of unemployment.

U.S. Bureau of Labor Statistics

Economic News Release – Released September 7, 2012

Table A-15. Alternative measures of labor underutilization

HOUSEHOLD DATA
Table A-15. Alternative measures of labor underutilization

[Percent]

Measure	Not seasonally adjusted			Seasonally adjusted					
	Aug. 2011	July 2012	Aug. 2012	Aug. 2011	Apr. 2012	May 2012	June 2012	July 2012	Aug. 2012
U-1 Persons unemployed 15 weeks or longer, as a percent of the civilian labor force	5.2	4.3	4.3	5.3	4.5	4.6	4.6	4.5	4.4
U-2 Job losers and persons who completed temporary jobs, as a percent of the civilian labor force	5.1	4.6	4.4	5.3	4.4	4.5	4.6	4.6	4.5
U-3 Total unemployed, as a percent of the civilian labor force (official unemployment rate)	9.1	8.6	8.2	9.1	8.1	8.2	8.2	8.3	8.1
U-4 Total unemployed plus discouraged workers, as a percent of the civilian labor force plus discouraged workers	9.6	9.1	8.7	9.6	8.7	8.7	8.7	8.8	8.6
U-5 Total unemployed, plus discouraged workers, plus all other persons marginally attached to the labor force, as a percent of the civilian labor force plus all persons marginally attached to the labor force	10.6	10.0	9.7	10.6	9.5	9.6	9.7	9.7	9.6
U-6 Total unemployed, plus all persons marginally attached to the labor force, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all persons marginally attached to the labor force	16.1	15.2	14.6	16.2	14.5	14.8	14.9	15.0	14.7

Reported Rate

Real Rate

NOTE: Persons marginally attached to the labor force are those who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the past 12 months. Discouraged workers, a subset of the marginally attached, have given a job-market related reason for not currently looking for work. Persons employed part time for economic reasons are those who want and are available for full-time work but have had to settle for a part-time schedule. Updated population controls are introduced annually with the release of January data.