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Investment Advisors, LLC

CHAPEL HILL, NC • CLINTON, NY

ANDREW C. BURNS
President/Chief Investment Officer
RICHARD S. WOODS
Chief Operating Officer

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Steinbrenner, Bernanke and Buffett

With debates raging about the fiscal health of our country and how best to further jumpstart a sluggish recovery, the Federal Reserve has recently grappled with renewed fears of deflation while the IRS's "accounts receivable" took a serious hit. George Steinbrenner headed for the "great ballpark in the sky," conveniently when the estate tax was temporarily zero, while Warren Buffett convinced his still-living billionaire friends to donate vast sums of their wealth to charity. In this Newsletter, we will discuss government fiscal and tax policy and ramifications for our investment outlook.

The Keynes Mutiny

The subject of government spending is topical as Washington and its Wall Street, escape-artist sympathizers promulgate myriad government solutions to our country's problems. The argument goes that government should increase spending in order to smooth the business cycle and keep unemployment rates low. In our view, any argument for stimulus should be predicated on the assumption that there is adequate *borrowing capacity* to fund deficits that will be only *temporary*. Without the supposition that borrowing capacity exists or belief the deficits will be temporary, the private sector, in preparing for future taxes and heightened uncertainty, will offset government efforts to stimulate by scaling back investment and consumption in order to increase savings and pay down debt.

Thus far, faulty assumptions have prevailed among policymakers with continued government borrowing supporting inefficient employment at state and federal levels while private sector job growth remains scant. Undeterred, Wall Street and their government friends declare successive bad statistics on housing and unemployment as "unexpected." For all the blame passed around about banks unwilling to lend, the real story is that, barring the rare special situations, those that can borrow new money don't want to (or only do so to refinance debt at a lower rate rather than invest) and those that do want to borrow, may struggle to pay it back.

Dr. Dolittle's Pushmi-Pullyu

Further compounding the debate over government stimulus is one regarding taxes and the pending expiration of the so-called Bush tax cuts in December. Both Timothy Geithner and Alan Greenspan, among others, recently argued that taxes should be raised next year in some form, which may be a good idea for all we know. However, it seems inconsistent to call for both stimulus and tax increases since they work in opposite directions, even when Keynesian logic otherwise holds. Rather than Washington's usual "muddled" approach, one policy (stimulus) or the other (long-term fiscal confidence) should be pursued with conviction. Meanwhile, the likes of Buffet and friends go about transferring as much wealth as possible to charity, placing those funds out of reach of Washington's future plans for estate taxes.

While we sympathize with those well-intentioned individuals trying to find workable solutions, the fact is we remain in the midst of a complex financial malaise with no clear, easy answers regardless of how many political speeches are made and op-eds written

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by respected economists. No wonder this leaves Ben Bernanke and the Federal Reserve pulling levers and pushing strings with short-term rates effectively at zero for the last two years (and foreseeable future) as he responds to deflationary indicators, while assuaging critics concerned with long-term inflation.

Americans Get Schooled

It should be obvious that we are far from blind optimism, but we are hopeful about a number of things. Central to that hope, is our belief that Americans are "quick studies," and just as we learned about other cultures and terrorist threats in the aftermath of 9-11, our citizenry are better macroeconomic experts since 2007. Americans are suspect when wages from private industry fall 5.8% while total government wages increase 2.6% as they did in 2009.[1] They are skeptical of the wisdom of additional deficits when government stretches further, confidence wanes and borrowing capacity seems to be reaching its limit.

In August 2008, we wrote that "America is a turnaround with potential." That sentiment still holds, but we are reaching the proverbial "tipping point" where confidence becomes difficult to restore and too much debt limits our flexibility to respond, thereby creating a negatively reinforcing loop. We think that Americans now sense this, and many believe it is time for the public sector to join the private sector in becoming more productive and that everyone must feel some pain for the country to head toward balance. As Americans gain further understanding of this situation, and bipartisan commissions like the one headed by Erskine Bowles and Alan Simpson advise Washington on a better way forward, solutions will emerge that may not directly address the short-term jobless rate, but dramatically enhance the long-term fiscal outlook.

Providing further reason for optimism, American households and non-profit organizations have $54.5 trillion of combined net worth, over $7.5 trillion of which is in cash deposits.[2] While that number is cold comfort if viewed only as a source of assets for government to go after, it dwarfs any government stimulus proposals and is encouraging when viewed as potential fuel for economic growth. The key is creating an environment that builds confidence in the private sector, and unleashes trillions for productive investments that, critically, would bring *sustained* prosperity.

Cash is King

Nonetheless, we are not idealistic enough to believe this transition can happen overnight or simply by electing new politicians. We continue to invest with a defensive posture, but are placated by holdings in high-quality companies with little or no debt and a collectively diversified revenue base from around the globe. These companies' stock prices are not immune to market volatility and performance cannot be guaranteed, but we believe their valuations imply the potential for solid, sustainable cash-on-cash returns, even in a low growth environment.

Our hope, thus, remains grounded in the reality that we expect continued market tumult and volatility as we (and the rest of the developed world) grapple with this tension between government efforts to manufacture immediate economic growth and those looking to restore private sector confidence as the catalyst for long-term growth. Meanwhile, we hope IRS risk managers have thought to purchase short-term life insurance on the likes of Warren Buffet in case they further complicate our government's problems by managing to give George Steinbrenner a heavenly high-five while the estate tax remains zero in 2010.

Andrew C. Burns
ABurns@HamiltonPoint.com

Richard S. Woods, CFA
RWoods@HamiltonPoint.com

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1 Department of Commerce, Bureau of Economic Analysis, Personal Income and Outlays: June 2010
2 Federal Reserve Flow of Funds Accounts: June 2010

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