EPIC
INVESTMENT MANAGEMENT

Issue 15 March 2013

Lefty and the Left Coast

Hall-of-Fame golfer Phil Mickelson is known for winning four majors, a deft touch around the greens, and an approachability that has long made him a fan favorite. But lately "Lefty" has earned headlines for a subject far out-of-bounds from typical golf talk -- taxes.

In a recent interview, Mickelson suggested "drastic changes" were in store for him, including possibly moving from his California home. The reason? Recent hikes in federal and state taxes that now carve out some 60 percent of his income. This comes just months after California's passage of Proposition 30, which raised the state tax rate to 13.3 percent on incomes over one million dollars.

On an estimated annual income of 50 million dollars, Mickelson will be facing over six million dollars in state income taxes. But consider what he gets for it.

California offers sunny skies and sandy beaches; redwood forests and majestic mountains; rolling hills and rugged deserts. Californians can golf, ski, surf, hike, bike, sail, among other activities, for the most part year-round.

Wait, there's more. California is blessed with temperate climate, fertile land, and abundant resources. Its agricultural capacity is enormous. Its coastline includes natural harbors. Few places on earth offer the blend of beauty, diversity, and self-sustainability that is California. This is what people get for living in California.

But here's the rub. None of these blessings are man-made; they are natural to California. Neither Mickelson nor anyone else in the Golden State should thank the government for the abundance and splendor of California.

So what does the government provide? Congested roads and over-crowded prisons; a public education system ranked well below national averages; a business climate rated among the worst in the nation; strict regulations and high taxes that send jobs either out of state or overseas; three bankrupt cities in the past year; the nation's third worst jobless rate, lowest credit rating, highest gasoline tax and highest state-wide sales tax. And for all those taxes, there is a perpetual fiscal problem that leads to still higher taxes.

This is what Lefty gets for his six million dollars.

So how did it get to this, where the failures of tax-and-spend government reach a breaking point? And when did multi-millionaires decide they can no longer afford the California lifestyle?

Here's a clue..

Over the past two decades, California's population grew by 26 percent. Over the same timeframe, US inflation totaled 64 percent cumulative. So if California state spending grew in proportion to population growth, adjusted for inflation, it would have increased by 107 percent. In truth, this figure is too high, as economies of scale and bargaining power should suppress the state's budget needs. Nevertheless, let's go with the 107 percent figure.

What happened? From 1992 to 2012, the state's Total Fund budget grew by 141 percent… this despite the real belt-tightening of the past few years. Multiply 34 percent over-spending by more than a hundred billion dollar budget, and you end up with a serious fiscal problem. Plain and simple, this is the issue. It's not that the tax code is goofy, or demographics have shifted(always for the worse), or the earth is too warm. Those have become standard excuses for a state that spends too much money.

Let's accept that Governor Brown inherited a mess, that the fault is certainly not his. Of course in California, it isn't anyone's fault. It just happens, over and over again. Here is what the Governor wrote in a previous budget proposal:

"The budget that I am submitting today keeps the cuts made last year and adds new ones. The stark truth is that without some new taxes, damaging cuts to schools, universities, public safety and our courts will only increase.

That is why I will ask the voters to approve a temporary tax increase on the wealthy, a modest and temporary increase in the sales tax and to guarantee that the new revenues be spent only on education."

It's just two short paragraphs, but history tells us there are three lies here:
1. Tax increases on the wealthy are not temporary.
2. A modest and temporary increase in the sales tax also will not be temporary.
3. The education plea is an old political trick, of spending "for the children". The added money was proposed to be spent on pension plans, of teachers. Call that "education" if you want, but don't expect any better scholastic results.

As Phil Mickelson reminds us, capital is mobile, and will go where it is treated best. This applies to individuals, small businesses, and large corporations; to stockholders, bondholders, and real estate investors. It's a basic tenet of finance. Maybe one day the concept will reach the Left Coast. After that, it's on to Washington.

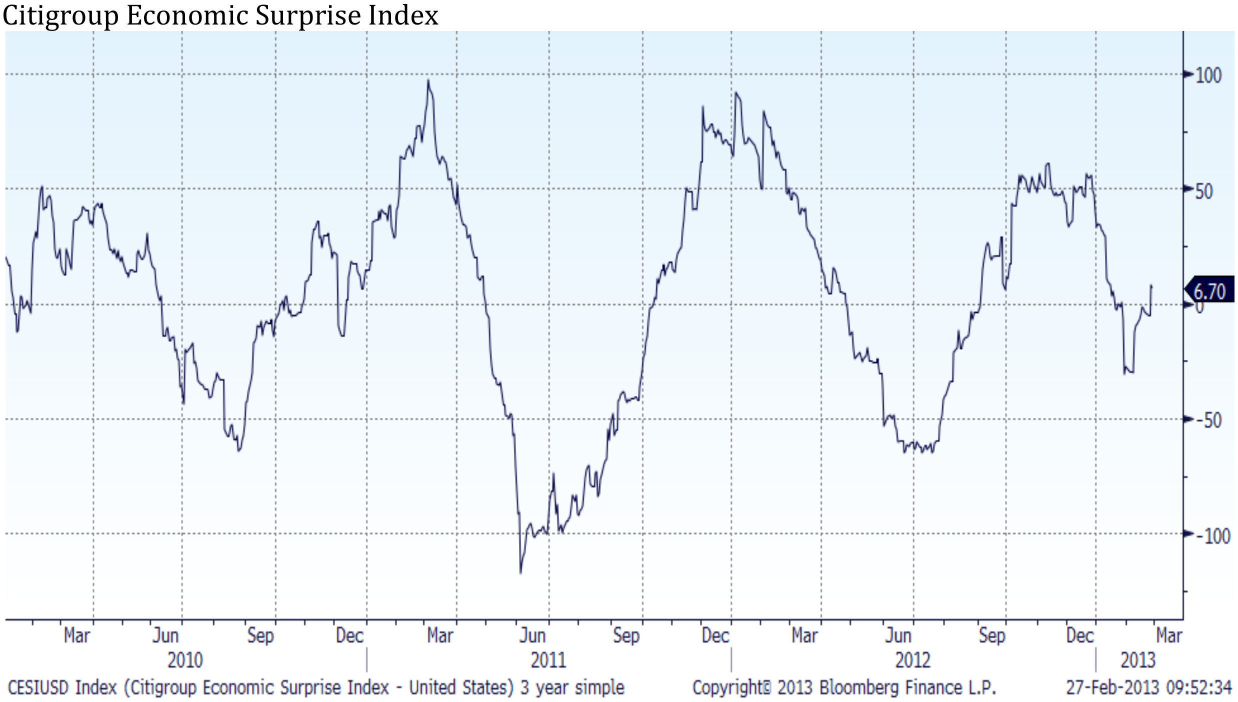
If Californians want to go along with the game, good for them. Soak the rich until they flee the state. Just remember that no government can tax-and-spend its way to prosperity.

Disconnected

The chart below shows the Citigroup Economic Surprise Index, which measures recent economic data against forecasts shortly ahead of the data release. The index does not tell us if the economy is expanding or contracting, but gives a sense of its momentum versus expectations.

For instance, fourth quarter change in real GDP was initially reported at -0.1 percent, whereas estimates called for +1.1 percent growth. This 'miss' versus expectations, a negative surprise, is reflected in the sharp decline in the index from zero to -30 in late January.

Citigroup Economic Surprise Index



This may be the biggest disconnect in today's markets. Economic data has been extremely disappointing since late December, including the weak GDP report. Yet, so far, equity markets do not care.. and they don't have to care. There is no rule that says stock prices must be supported by strong economic activity. The two can move at varying degrees, or even in opposite directions. Nevertheless, the current condition is a disconnect -- a divergence from what is typical -- and bears watching.

Sources:
Bloomberg
California Legislative Analysts Office
Tax Foundation
US Department of Labor
Wall Street Journal
Wikipedia

Tidbits..

Fiscal cliff avoided, taxes raised for most Americans, spending cuts debated while government programs expand.

New year, same old Washington.

US healthcare spending reaches 2.7 trillion dollars, grows at record-low four percent pace.

Still the elephant in the room for economy, federal spending.

UPS acquisition of Europe's TNT Express is blocked by regulators.

European Union proposes stricter rules on ratings agencies, in bid to protect high Sovereign credit ratings.

Shoot the messenger!

World Bank cuts 2013 global growth forecast to 2.4 percent

Still cutting estimates, still too high?

Boeing 787 Dreamliner is grounded for safety reasons.

Bank of Japan adopts higher inflation target, asset purchase program, as remedy for ailing economy.

Free money policy goes global.

Union membership, at 11.3 percent of US workforce, falls to lowest level in nearly a century.

Worldwide stock correlations plummet at fastest rate in two decades.

After six years of 'risk on/risk off', a welcomed move toward normalcy, stock selection.

Consumer confidence drops to lowest level in over a year.
US GDP goes stagnant in fourth quarter 2012.

Justice Department files suit against Standard & Poor's over faulty credit ratings.

Computer maker Dell, Inc. agrees to 24 billion dollar management-led buyout.
Berkshire Hathaway, 3G Capital team up to purchase HJ Heinz in 28 billion dollar buyout.
US Airways to merge with bankrupt AMR, parent of American Airlines, forming world's largest airline.

With cheap money and reasonable valuations, expect more mergers, buyouts.

China surpasses US as world's largest trading nation.

US supply of existing homes for sale drops to 13 year low.

In reversal of fortune, suddenly a seller's market for housing.