EPIC
INVESTMENT MANAGEMENT

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The New Patriots

Beware the clever slogan.
New Deal, Great Society, War on Poverty. Perhaps well-meaning programs, they were packaged for propaganda, designed to stir the masses into popular support. The new incarnation is "Economic Patriotism', as meaningless a phrase as could be invented. The target, though, is real: to demonize businesses engaging in cross-border merger activity; to stop companies from moving their domicile outside the US, thereby lowering their taxes, in what is known as a corporate inversion.

As examples, two U.S.-based drug firms, AbbVie and Mylan, recently announced plans for foreign mergers that will move their domiciles overseas. AbbVie will become a UK-based firm, while Mylan will be moving to The Netherlands. The Wall Street Journal recently counted 14 inversion deals this year, with more almost certain to come.

To big government, the loss of jobs seems an inconvenience; the loss of taxes borders on economic desertion. Thus the phony appeal to patriotism.

Waving the Patriots' flag for the Administration is Treasury Secretary Jack Lew. In a recent letter to members of Congress, Secretary Lew wrote:

"In recent months, there have been reports of a number of corporate inversion transactions designed to change the tax domicile of a U.S.-based multinational firm with minimal change in its business operations. These transactions involve the purchase of a foreign corporation (generally in a country with a much lower corporate tax rate and generous rules for shifting income between countries), the transfer of tax domicile to the foreign firm's country of incorporation, and the shifting of tax liability for the combined firm to the new foreign tax domicile.

Recently announced transactions cover a wide range of industries including pharmaceuticals, retail, consumer, and manufacturing. The firms involved in these transactions still expect to benefit from their business location in the United States, with our protection of intellectual property rights, our support of research and development, our investment climate, and our infrastructure, all funded by various levels of government. But these firms are attempting to avoid paying taxes here, notwithstanding the benefits they gain from being located in the United States.

The best way to address this situation is through business tax reform that lowers the corporate tax rate, broadens the tax base, closes loopholes, and simplifies the tax system."

Secretary Lew should have stopped right there, before his sensibility could be called into question. But he couldn't help himself, continuing..

"But, even as we work to do that, we should prevent companies from effectively renouncing their citizenship to get out of paying taxes. That is why President Obama included in his Fiscal Year 2015 Budget a proposal to ensure that companies could not change their corporate tax domicile without a change in control of the company itself. Senators Ron Wyden and Carl Levin and Congressman Sander Levin and Chris Van Hollen have supported this idea in Congress and have put companies on notice that any transaction that takes place after early May 2014 will not have the desired effect of lowering future U.S. tax liabilities. Congress should enact legislation immediately -- and make it retroactive to May 2014 -- to shut down this abuse of our tax system.

What we need as a nation is a new sense of economic patriotism, where we all rise or fall together. We know that the American economy grows best when the middle class participates fully and when the economy grows from the middle out. We should not be providing support for corporations that seek to shift their profits overseas to avoid paying their fair share of taxes."

Good grief.

Not to skewer the messenger, but this is the same Jack Lew who previously worked as an executive at Citigroup, the too-big-to-fail bank that received a government rescue to the tune of several hundred billion dollars in direct investment and loan guarantees. Reports show that Mr. Lew benefited from favorable treatment -- accelerated vesting of his Citigroup equity -- upon leaving the company for Washington. Take a bailout. Take the money and run. Now he is preaching about 'Economic Patriotism'?

The aforementioned Senator Wyden, whom Mr. Lew cites as an ally in his battle, recently called the American tax code a "rotting mess of a carcass." With endorsements like that…

On to the merits, focusing on three issues: The World Is Flat, Whose Business Is It?, and The Numbers Don't Add Up.

The World Is Flat.

Thomas Friedman popularized this phrase nearly a decade ago, describing the rise of globalization in the world's economy. A reasonable expectation from this grand concept would be that traditional market barriers will be torn down; that competition will arise from ideas, technologies, work forces, and economic regimes either non-existent or irrelevant in decades past. Why should taxes be any different?

The U.S. has the highest corporate income-tax rate in the developed world, with a federal rate at 35 percent, and a combined federal, state and local rate estimated to average out to 39 percent. In tax-loving France, the corporate rate is 34 percent; in Germany it is 30 percent. The UK recently embraced tax reform, lowering its rate to 21 percent. Ireland has long been ahead in the game, with a tax rate of 12.5 percent driving an economic miracle until a housing bust and the great recession turned the Emerald Isle into a disaster area. In South America, Chile has for decades been the 'renegade regime' of free enterprise; its tax rate is 20 percent.

So what of the U.S.?

According to Laura Tyson, former chairwoman of President Clinton's Council of Economic Advisers, "America's relatively high rate encourages U.S. companies to locate their investment, production, and employment in foreign countries, and discourages foreign companies from locating in the U.S., which means slower growth, fewer jobs, smaller productivity gains, and lower real wages."

Besides the high statutory rate, the U.S. uses a punitive 'worldwide' system of international taxation. American companies pay taxes in the country where a profit is earned, then pay an additional tax when the profits are repatriated to the U.S. This creates an incentive to keep any accumulated profits offshore as an indefinite and legal tax shield. When the time comes to re-invest those profits, the U.S. ranks as the high-cost alternative in a competitive world. It's all written into our tax code, and it's all counter-productive to our own interests.

Robert Coury is executive chairman of drug company Mylan. His thoughts on the inversion issue, recently printed in USA Today, are excerpted here:

"America's system of worldwide corporate taxation was enacted the year after Mylan was founded (1961). Since then, our industry and the global economy have changed dramatically, but our tax code has not. While we sell products in 140 countries, the U.S. is one of the only countries that taxes companies on income that was earned (and already taxed) in another country. All of our major competitors were either founded outside of the U.S. or have recently inverted, and benefit from more attractive tax structures. This significant competitive disadvantage could put our corporation, and all of our high-quality U.S. jobs, at risk.

To continue to succeed, we cannot stand still. Recently, we announced an agreement to acquire a business from Abbott Laboratories that will diversify and strengthen our business. It also allows us to implement a global tax structure that will enable us to compete more effectively in the global economy. Despite this transaction, Mylan will still pay U.S. taxes on the money we earn here.

Corporate taxes can be complicated, but this situation is really no different than how your family decides where to live. It's why many members of Congress live in Maryland or Virginia rather than Washington, D.C. The lower your tax rate, the more you have to spend on things like home improvements or college tuition. If your friends and family have a lower tax rate than you, they can afford to pay more for those things and you can't keep up.

The same applies here. Our competitors have significantly lower tax rates and therefore can afford to invest more in their businesses. This disparity in taxes potentially makes us an easier acquisition target, which could result in the downsizing or elimination of our U.S. facilities and workforce. This debate should not be about 'patriotism'. Calling an inversion unpatriotic is the equivalent of saying Americans are not patriotic when they don't buy American. This is simply not realistic in today's world.

If Mylan can find itself in this situation, so can any American company, or for that matter any citizen. Perhaps the next target will be individuals who seek professional advice to lower their taxes. Does that make them unpatriotic?

Patriotism is defined as having great love for your country. We do love this country -- enough to fight for the jobs that are in it and push for the changes that are needed to save the American dream…"

Whose Business Is It?

Note the rhetorical appeal from Secretary Lew, a common refrain from the White House and certain members of Congress:

"The firms involved in these transactions still expect to benefit from their business location in the United States, with our protection of intellectual property rights, our support of research and development, our investment climate, and our infrastructure, all funded by various levels of government. But these firms are attempting to avoid paying taxes here, notwithstanding the benefits they gain from being located in the United States."

To state what should be obvious, the businesses in question have paid their fair share in achieving success or failure in the U.S. market. U.S. companies typically face high legal and regulatory costs; fund employee healthcare plans and retirement accounts; hire workers and pay their salaries; fund payroll taxes.. and then, if there is any profit remaining, pay the developed world's highest income tax rate. Each year, they start over, with no guarantee of success.

The stakeholders in American businesses include owners, creditors, employees, customers, and local communities. Now the government wants to be a stakeholder, to assert its claim on privately-owned assets. When the President says "If you've got a business, you didn't build that..", this is where he is going. Politicians should know their boundaries -- a corporation is not a national treasure, is not the Grand Canyon or the Alaskan oil fields. It is not a stake to be claimed.

Moreover, on each of the U.S.-based benefits cited by Secretary Lew, the gain is exaggerated. Protection of intellectual property rights? These rights are well protected in Canada, the U.K., and the Euro Zone. Consider that America's legal system is among the most litigious and expensive in the world. Patent trolling is a costly American invention. Tort reform is at least 20 years overdue, especially regarding health care services.

Research and Development? Sure, the U.S. funds basic research, but which of these inverting companies was a beneficiary? Mylan is a generic drug company moving to the Netherlands. The essence of the generic drug industry is copying existing drugs that are losing patent protection. The business is more legal enterprise than cutting edge science. Burger King is leaving for Canada. Does the White House claim to have invented the Whopper?

What is our investment climate, other than an ongoing war on free enterprise? It's true, the U.S. has large stock and bond markets, and a well-established banking system. Yet these markets are open to foreign-based firms competing here. Likewise, European markets offer similar access to capital.

Then there is infrastructure, which is to say America's crumbling bridges, crowded highways, and even its mediocre internet service. All companies with a U.S. presence, regardless of domicile, continue to fund this infrastructure through normal means -- fuel taxes, communications taxes, and any other special taxes the government can impose.

It just may be that our leaders over-estimate the benefits of a U.S. headquarters. What companies really want is access to our marketplace, the world's largest economy. That access generally does not inquire about domicile or citizenship, and it should not include a government claim.

The Numbers Don't Add Up.

The federal government takes in 300 billion dollars from corporate taxes per year. Before the great recession, the level was 383 billion dollars. So our government has lost 83 billion dollars in annual taxes since 2007, despite corporate profits setting record highs. Something is wrong. Try this explanation: In a competitive world, high tax rates lead to low tax receipts.

The 300 billion dollars in corporate taxes represent ten percent of federal revenues, and less than two percent of U.S. Gross Domestic Product (GDP). If the corporate tax were eliminated altogether, and there were no subsequent benefits to our nation's budget, this year's federal deficit would increase from 2.9 percent of GDP to 4.6 percent. But there would be benefits. Capital would pour into our economy, creating more jobs. This would mean higher personal income taxes paid into the U.S. Treasury, with lower unemployment and other support payments going out. With a corporate tax rate of zero, the deficit would increase, yet the economy would improve and the middle class might regain its footing. Too radical? Split the difference, setting the rate at 18 percent.

In Congress, the Joint Committee on Taxation recently revealed the estimated revenues to be gained from passing the "Stop Corporate Inversions Act of 2014". This proposal makes it harder for corporations to invert and move overseas. The Committee estimates that the 'Inversions Act' will raise 19.5 billion dollars over a decade, or just under two billion dollars per year.

Over the next decade, the corporate income tax is estimated to raise 4.5 trillion dollars. The 'Inversions Act' tax boost would account for less than one percent of corporate taxes alone.

Next, compare the 'Inversions Act' tax boost to federal spending, currently running at 3.65 trillion dollars and sure to increase in future years. Check the math, but it sounds like the federal government spends ten billion dollars per day. The two billion dollars in annual taxes raised by blocking inversions would amount to five hours of federal government spending. And that assumes the government works for us around the clock. Sure it does.

All this bluster over so little money? Perhaps 'Economic Patriotism' is one too many clever slogans.

Punch Bowls and Superheroes

Being a central banker cannot be easy. If economics is the dismal science, at least it is filled with people who are far from dismal themselves; people who offer insight into what can be the most basic, and complex, human behaviors -- buying and selling of goods and services, allocation of scarce resources, and creation of wealth.

As economists morph into central bankers, 'Free To Choose' and 'Freakonomics' give way to 'term structure of interest rates'. It gets dull pretty quickly. This is what happens when, as a central banker, you serve two primary functions. First, you regulate the banking system, a job worthy of a Washington technocrat is ever there was one. Second, you control the money supply, a task the late Nobel laureate Milton Friedman argued would be better performed by a computer.

So a central banker will seldom be considered the life of the party, especially when following the admonition of the late Federal Reserve Board Chairman William McChesney Martin, who famously quipped that the job of the Federal Reserve is to "take away the punch bowl just when the party is getting good".

Adding to the woes of the Federal Reserve Chair is the requirement to testify before Congress. This means that a purportedly independent central bank, in some sense answers to the Legislative branch. That is, the people who serve as guardians of our currency and banking system report to people who would gladly spend money to buy votes.

To provide comic relief, Congress typically asks long-winded questions with no real purpose. Historically, the Fed Chair would adroitly dance around the issue, running out the clock until each Congressman's time expired. At least that is the way it used to work. Further amusement may be found in the assortment of opinions offered during this testimony. A fair sample would find that one-third of Congress believes the Fed's monetary policy is too loose, one-third believes it is too tight, and 99 percent have no idea how ignorant they sound.

So it cannot be fun working as a central banker, no matter how much money you are allowed to print.

As if dealing with Congress is not enough, lately the Federal Reserve has faced a new worst enemy.. the Federal Reserve. There was a time when the Fed was cloaked in secrecy. We only knew its policy intentions by reading the market tea leaves. If short-term rates rose, it must be because the Fed wanted higher rates. Economic projections -- that is, educated guesses -- were left to Wall Street economists. The Fed set policy, it did not publicize guesses.

Those days are over.

Roughly a year ago, the Federal Reserve prepared financial markets for the phase-out of the Fed's Quantitative Easing program, otherwise known as QE3. At the last minute, the Fed pulled a fast one on the markets, deciding the world, or at least the US economy, was not ready for this

stimulus program to end. While the policy decision may have been correct, the Fed certainly blew its delivery.

Since then, the Fed has reneged on several other promises. Okay, when you are a central banker, you do not make promises; rather, you offer guidance. And that guidance included expectations of tighter monetary policy when the unemployment rate pierced below six and a half percent, or when inflation neared two percent.

But it's silly how markets get caught up in numbers. Neither the unemployment rate nor the inflation rate targets are hard and fast thresholds. How do we know this? The economy called the Fed's bluff, and the Fed flinched. Apparently, there is no policy guidance that cannot be revised to suit our central bank's desire for emergency liquidity provisions. So why offer any guidance at all?

Here's a summary of recent economic news:
First Quarter Gross Domestic Product (GDP), an aberrational decline, was revised to a stronger number. The first quarter was weak, down 2.1 percent, but not as weak as previously reported.
Second Quarter GDP, projected to show a strong rebound, grew at a better than expected 4.2 percent rate.
The Unemployment Rate fell to 6.1 percent, the lowest level since 2008.
Non-farm payrolls have grown by over 200,000 for six consecutive months, the longest stretch since 1997.
Initial jobless claims dropped to the lowest level since 2000.
Continuing jobless claims dropped to the lowest level since 2007.
Inflation, on several measures, is up to the Fed's two percent target, and accelerating.
The service industry, as measured by The Institute of Supply Management (ISM) index, expanded at the fastest pace since 2005.
The 'JOLTS' survey of job openings is at its highest level since 2001.

That's what the data says. Newly-appointed Fed Vice-Chairman Stanley Fisher sees it differently. In a recent speech, he was counted using the word 'disappoint' five times, while 'slow' or 'slowdown' appeared 16 times. Fed Chair Janet Yellen always has a moving benchmark to support her easy-money view. When unemployment drops below Fed expectations, the weak labor participation rate is to blame. When job openings grow to decade highs, wage growth is still weak. Did the bank's economists not foresee this? To the Fed, the glass is not half empty -- it is broken, and only the Fed can fix it.

Before retiring as Federal Reserve Bank Chairman, Ben Bernanke tried to assure markets that the weakness in the US economy was cyclical, not structural. Declining US education standards? Not a problem. Globalization and declining US competitiveness? Not a problem. Excessive debt, constrictive regulation, and an arcane tax code? Not a problem.

Since leaving the Fed, Mr. Bernanke has been busy on the speaking circuit, and has offered his thoughts on the future of interest rates. The most startling prediction was that the Federal Funds

rate, a benchmark for short-term rates, would not reach its four-percent historical norm in Mr. Bernanke's lifetime. As the former Fed Chairman is a spritely 60 years of age, we presume his timeframe refers to decades, not just years. The contradiction is obvious. If our nation's economic woes are merely cyclical, then interest rates should normalize in a matter of a few years. If the problems are structural, then Mr. Bernanke should be advocating structural reform. Pick one, Mr. Chairman.

Where does all this leave Fed policy? Short-term interest rates are anchored near zero, and the Fed is still buying mortgage and Treasury securities as part of its Quantitative Easing program. In layman's terms, monetary policy is not easy, nor very easy; it is accommodative at the level of emergency conditions. This as our economy enters its sixth year of expansion.

Meanwhile, it is increasingly difficult to trust anything the Fed says, except that policy will remain accommodative. That one is easy to believe.

Investors need not complain. Fed policy has rewarded investors nicely, with both stock and bond markets sharing the spoils. Easy money makes for higher prices. But the Fed's prior easy money policies led us right into the housing bubble and subsequent collapse. Before that, there was the tech bubble, with the Fed playing less than a leading role, but still in the picture. Distortive policy makes for distorted markets, and for two decades running, the Fed has repeatedly erred on the side of loose policy. To top it off, now the Fed suffers from institutional blathering. It talks too much, and reminds us that the best and brightest in American Finance are not working at the Federal Reserve.

Common criticisms of Fed policy warn that easy money inevitably leads to inflation, and that the Fed will one day need to sell its bond holdings, overwhelming the bond market. These fears may be overblown. The inflation concern is valid, but has been cited for years by Fed critics, who love describing our central bank as 'behind the curve'; and a bit more inflation may not be the worst thing in the world. On the second issue -- that of the Fed eventually unwinding its positions -- it is not clear that the Fed will ever need to do so.

There are more immediate and tangible problems with Federal Reserve policy, among them:
In a nation loaded with borrowers, it is the people who have acted responsibly -- savers and retirees -- who are suffering from ultra-low rates. Why punish them?
While government and large corporations can borrow big money on favorable terms, small businesses are not invited to the party. So too for many home buyers. Low rates don't help if nobody will write you a loan. The fat cats get fatter while middle-America suffers.
Most important, the Fed is providing cover for failures of fiscal, tax, and regulatory policy. As Congress and the White House ignore the structural issues plaguing our economy, the Fed just throws more money at the problem; and the problem grows larger. The Fed has become our nation's enabler.

If institutions have a mindset all their own, it is not a stretch to presume the Fed's current psyche is to see itself as a Superhero. Every problem is a crisis about to explode, and when you play a

Superhero, you can't help but save the day. Find a phone booth and don that cape! But six years after, and still in emergency mode?

Back to the required Congressional testimony, painful as it may be. Once, just once, it would be nice to hear this message delivered by the Fed Chair at one of those hearings:
"Congressman, the problem with the US economy is not monetary policy. The problem is a hare-brained tax policy, a suffocating regulatory regime, a long-term budget deficit that will drive a stake through the economy, and a demonization of capitalism. Those issues are not of the Fed's making. They are your doing, and only you can fix them. The Fed is done providing cover for you. We're taking our punch bowl and going home."

Now that would be worthy of Superhero status.

The Blue-State Path to Inequality
Excerpted from The Wall Street Journal
By Stephen Moore and *Richard Vedder*

The Gini coefficient, a standard measure of income inequality, calculates the ratio of income at the top of the income scale relative to the income of those at the bottom. The higher the ratio, the more inequality. A Gini coefficient of zero means perfect equality of income and a Gini coefficient of one represents perfect inequality, such as if one person has all the income.

According to 2012 Census Bureau data (the latest available figures), the District of Columbia, New York, Connecticut, Mississippi and Louisiana have the highest measure of income inequality of all the states; Wyoming, Alaska, Utah, Hawaii and New Hampshire have the lowest Gini coefficients. The three places that are most unequal -- Washington, D.C., New York and Connecticut -- are dominated by liberal policies and politicians. Four of the five states with the lowest Gini coefficients -- Wyoming, Alaska, Utah and New Hampshire -- are generally red states.

In the Northeast, the state with the lowest Gini coefficient is New Hampshire, which has no income tax and a lower overall state tax burden than that of its much more liberal neighbors Massachusetts and Vermont. Texas is often regarded as an unregulated Wild West of winner-take-all-capitalism, while California is held up as the model of progressive government. Yet Texas has a lower Gini coefficient and a lower poverty rate than California.

Do the 19 states with minimum wages above the $7.25 federal minimum have lower income inequality? Sorry, no. States with a super minimum wage like Connecticut ($8.70), California ($8), New York ($8) and Vermont ($8.73) have significantly wider gaps between rich and poor than those states that don't.

What about welfare benefits? A Cato Institute report, "The Work Versus Welfare Trade-Off: 2013", measured the value of all welfare benefits by state in 2012. In general, the higher the benefit package, the higher the Gini coefficient. States with high income-tax rates aren't any more equal than states with no income tax. The Gini coefficient measures pretax, not after-tax income, and it does not count most sources of noncash welfare benefits. Still, there is little evidence over time that progressive policies reduce income inequality.

When politicians get fixated on closing income gaps rather than creating an overall climate conducive to prosperity, middle- and lower-income groups suffer most and income inequality rises. The past five years are a case in point. Though a raft of President Obama's policies -- such as expanding the earned-income tax credit and food stamps, and extending unemployment benefits -- have been designed to more fairly distribute wealth, inequality has unambiguously risen on his watch. Those at the top have seen gains, especially from the booming stock market, while middle-class real incomes have fallen by about $1,800 since the recovery started in June 2009.

This is a reversal from the 1980s and '90s when almost all income groups enjoyed gains. The Gini coefficient for the United States has risen in each of the last three years and was higher in 2012

than when George W. Bush left office, though Mr. Bush was denounced for economic policies, especially on taxes, that allegedly favored "the rich."

Our view is that John F. Kennedy had it right that a rising tide lifts all boats. It would be better for low- and middle-income Americans if growth and not equality became the driving policy goal in the states and in Washington, D.C.

Source:
American Enterprise Institute
Bloomberg
Congressional Budget Office
Office of Management and Budget
Quoteinvestigator.com
Tax Foundation
USA Today
Wall Street Journal
Wikipedia

Tidbits..

Mylan to buy generic drug business of Abbott Labs for five billion dollars, move to Netherlands domicile, lower tax rate.
Dollar Tree, Dollar General enter bidding war to acquire Family Dollar Stores in nine billion dollar merger of discount retailers.
Burger King to acquire Tim Hortons for 11 billion dollars, move headquarters to Canada.
Reynolds American to buy tobacco rival Lorillard in 27 billion dollar deal.
Abbvie reaches 55 billion dollar merger agreement with Shire, gaining UK tax benefits.
Twenty-First Century Fox proposes, then withdraws, 80 billion dollar media mega-merger with Time Warner.

Supreme Court rules Aereo streaming video service violates copyright law.

Broadcasters win; Aereo in danger of going the way of Napster.

Federal Reserve commentary cites excessive valuation in select areas of stock market, reasonable pricing overall.

The ghost of irrational exuberance begins to stir.

Moody's warns that RadioShack is likely to run out of cash by third quarter of 2015.
Sears Holdings loses money for 14th straight quarter, as sales decline for 30th consecutive quarter.

The slowest corporate deaths in history?

Procter & Gamble, after decades of brand building, looks to divest over half its brands in effort to become lean and nimble.

Business model: expand, purge, repeat.

Two-year government notes in Europe -- including Switzerland, Germany, France -- priced at negative yields.
High yield bond funds face record outflows as investors cash in gains.

Quest for yield in battle against common sense.

US home prices rise 4.4 percent in past 12 months, slowest pace since 2012.

Atlantic City faces crisis as four casinos close this year.

After four decades, opportunity lost for Atlantic City.

Congressional Budget Office releases long-term budget outlook, sees continuously rising debt levels after 2017, warns the budget condition is 'unsustainable'.

Congress sleeps through its wake-up call.

Argentina defaults on its sovereign debt for second time in 13 years.

Como se dice 'basket case'?