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• *One Man's Opinions - Spring 2010*

ONE MAN'S OPINIONS – SPRING 2010

A REPUBLIC MADAM, IF YOU CAN KEEP IT!

This newsletter marks thirty four years of my attempting to inform, stimulate, and educate my readers quarterly or, in the early days, more often as the situation warranted. Nowadays, of course, I do a weekly blog, so One Man's Opinions is now on a regular quarterly schedule. Here I try to focus on broader issues of the day, not necessarily a specific topic, as in the blogs. This issue may well be among the more important and significant of all its predecessors. I have deliberately written this part BEFORE the U.S. House of Representatives vote on the Obama Care health proposal.

I recently finished a biography of Benjamin Franklin by Walter Isaacson. It is an excellent read on the life of the man who, perhaps more than any other of our founding fathers, understood and encouraged the potential of our country. I read Franklin's autobiography as a young man, and have benefited greatly from the ideas and ideals he expounded in that missive. I highly recommend this book as a supplement to the autobiography as it gives much more background into the person and the life of the man who, with due respect to George Washington and Abe Lincoln, may well have been our "Greatest American."

Shortly after the Constitution of the United States of America was adopted, a lady asked; "what have you given us Dr. Franklin, a monarchy or a republic?" Franklin replied, "A republic Madam, if you can keep it!" Franklin probably had more input into this marvelous document than any other drafter of this cornerstone of our country. His cautious response to the question was absolutely appropriate both then and now. Were he still alive I think he would share my great doubt about the ability of today's American people and our leaders to keep us the greatest country in the history of this earth.

My doubt is rooted in the obvious inability of either party in our Congress, nor our most recent elected Presidents, to behave in a fiscally wise and sound manner when executing the business of governing our country. This has been going on since World War II, and can be traced further back to the Roosevelt administration in the 1930s, when spending far beyond revenues became commonplace. But FDR and his minions were underachievers compared to modern politicians.

With the possible exceptions of the Reagan presidency, that of John Kennedy, and the Republican Congress of the late 1990s, our Congress and our administrations have continued to spend more and more and more on "entitlements," and have failed to raise taxes sufficiently to pay for all these goodies, lest it upset the voters. Huge deficits have become routine. With the current administration and Congress, there seems NO concern at all about doubling and tripling the current deficit, and it now looks like we are headed for far worse. Let's look at the situation.

By 2020 U.S. government spending is projected to equal 26% of our Gross National Product, the sum total of all financial affairs in the U.S. Even worse, taxes are on pace to equal just 19% of GDP. President Obama recently appointed a Commission of ten Democrats and eight Republicans to “make recommendations” as to what to do about these deficits. Do?? Mr. Obama’s own budget director Peter Orszag was quoted soon after as saying, “By any reasonable projection we are on an utterly unsustainable path!” Presidential commissions are notoriously ignored by elected politicians, but I devoutly hope they will not be this time. If not finally addressed, this situation can bring down the United States of America! With that statement, I do not mean bankruptcy. A sovereign nation with taxing powers cannot go bankrupt. But look at Argentina, which has twice canceled its debts and which has become an economic basket case in the past sixty years. This is where we are headed!

Even if the Commission comes up with proposals that the Congress and the administration can accept, a tall order indeed, political leaders in both parties are in denial about what the solutions will entail. As is much of the public! Between them, and their leaders, I doubt they/we can keep our Republic!

What needs to happen? The biggest hurdle in solving the deficit problem is politics, not economics. Taxes must rise and spending MUST be cut! No one likes the idea of paying more taxes and/or having benefits cut. But taxes will need to rise on far more than the top 5% of the income bracket, those over \$250,000. There are simply not enough of the latter to solve the problem. And it cannot be restricted to just taxing income on the top 50%, it MUST go broader than that, otherwise the bottom 50% will continue to vote themselves a greater and greater share of the top earners income. This has been going on since the income tax was enacted (originally in 1913, and only one percent on income of more than \$1million!). No, the poor must also pay a share, although not a proportionate share, of the cost of entitlements. I suggest a 2-4% national sales tax. Every industrialized country in the world except Saudi Arabia and the United States has some kind of consumption tax. A modest one would give citizens more incentive to save and invest, yet it would raise significant (and almost painless) revenue. In an ideal world, such a consumption tax would be far higher and REPLACE our tax on work, the income tax. But I am sure this is not possible in our nation today.

But a solution that relies only on raising taxes will not work either. To do so would muzzle economic growth and thus be self-defeating. To cover the costs of future spending already on the books, the retirement of the baby-boomers, their Medicare, and the relief of individual state’s required spending on Medicaid, taxes would have to be raised immediately and permanently by 50%! Obviously this is not possible. Benefits and entitlements MUST be adjusted.

Fortunately this does not have to be done all at once in a way that might ruin our still struggling economy. Instead we could, and should, begin to phase in a later and later full retirement age, say eventually up to age 70 or 72, for Social Security. Medicare could also be phased in similarly. The base on inflation adjustments on Social Security can immediately be changed to cost of living from the wage index, which tends to be about 1% higher than the cost of living. Why should we social security recipients receive compensation based on productivity improvements in wages? This change alone would stabilize the program.

Medicaid can be strengthened by insisting on co-payments for all but the most destitute. Health care, especially with Obama Care, is easily the biggest challenge facing us. Not only are more people in their 50s and 60s likely to live into their 80s and beyond, continuing technical advances promise individual medical care will continue to be more and more expensive. We cannot keep borrowing the

money to pay for these benefits. The same is true for prescription drugs, although many miracle drugs will become generic, and thus far less expensive, in the next few years.

On a similar line, tort reform **MUST** be implemented, no matter how strong the trial lawyers lobby may be. It is estimated that 30% of all medical tests ordered by physicians are not necessary, but are done as a defense against possible malpractice suits. This is insane! Indiana has a thirty year old system that caps malpractice awards at reasonable levels and still compensates victims in instances of true mistakes. Under guidelines, Indiana judges handle most of these situations without jury trials in which trial lawyers appeal to the emotions of unsophisticated and/or ignorant jurors.

“Earmarks” attached to legislation without debate (or even the knowledge of them) in the Congress should immediately be identified as what they are, bribes of voters, and forbidden unless they receive an up or down vote in the legislature.

Written March 27. Now I turn to the new “Health Care Reform Act” which was just passed. Despite the propaganda, this is a **NEW** entitlement for 15-20 million American citizens. It is **FULL** of provisions which will sharply increase costs, in most cases years before corresponding benefits. We needed health care reform. We did not need to put the government in charge of one sixth of our economy. The government **NEVER** can do things more efficiently than the private sector. More effectively sometimes, such as our U.S. military, but no one argues the military is efficient, no matter how effective they can be, such as in Haiti in recent months.

Last week David Brooks of the New York Times, hardly a conservative, had some remarks in his column in the New York Times, certainly a liberal newspaper. I quote in part; “The second biggest threat to American vibrancy is the exploding debt. Democrats can utter the words of fiscal restraint, but they do not feel the passion. This bill is full of gimmicks designed to get a good score from the Congressional Budget Office, but not to really balance the budget. Democrats did enough to solve their political problem (not looking fiscally reckless) but not enough to solve the genuine problem. “

Brooks continues; “Nobody knows how this bill will work out. It is an undertaking exponentially more complex than the Iraqi War, for example. But to me, it feels like the end of something, not the beginning of something. It feels like the noble completion of the great liberal project to build a comprehensive welfare system.”

“The task ahead is to save this country from stagnation and fiscal ruin,” he further says. “We know what it will take. We will have to (enact) a consumption tax. We will have to preserve benefits for the poor and cut (benefits) from the middle and upper classes. We will have to invest more in innovation and in human capital.” (Where are the doctors, nurses, and technicians going to come from to treat all these additional millions of patients?)

Brooks concludes; “The Democratic Party, as it revealed itself over the past year, does not seem to be up to the coming challenge. Neither is the Republican Party. This country is in the position of a free-spending family careening toward bankruptcy that at the last moment announced that it is giving a gigantic new gift to charity. You admire the act of generosity, but you wish that they had sold a few of the Mercedes to pay for it”

Mr. Brooks says it all, and says it far better than I can. I probably won't live long enough to see this great country wreck itself. I hope our leaders come to their senses. But I don't see any signs that, as a

group, they get it! My grandchildren and great-grandchildren (almost 11 of these now) will live in a different environment than I have. And they, and their descendants, will still be paying interest on the debts run up by this current generation of leaders and their predecessors. I hope I am wrong!

All this being said, on the investment front, we investors have no place else to hide but in quality common stocks. I expect an eventual lowering of the AAA credit rating of United States debt. This means the price of currently held bonds will go down in price, interest paid will have to go up. U.S. government TIPS, which adjust for inflation, which I expect to surge in three to five years, will also be negatively impacted. And they currently pay very modest real interest rates. Real estate is probably a buy now for cash buyers of certain specific properties. But mortgage money remains tight, so does bank credit in general. Investors are hard pressed to take down leverage on all but the highest quality properties. Hold or add to common stock portfolios to protect against inflation.

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