



MUHLENKAMP AND COMPANY, INC.

INTELLIGENT INVESTMENT MANAGEMENT

12300 Perry Highway • Wexford, PA 15090 • (724) 935-5520 • (800) 860-3863

e-mail: [click here](#) home page: www.muhlenkamp.com

Issue 16, Fourth Quarter 1990

A TOUGH, TOUGH QUARTER

In July, we were congratulating the Fed on engineering a slowdown in the U.S. economy with a minimum of pain and dislocation. The Fed was nearing its stated economic goals and it looked to us like it could soon begin easing credit to allow growth to begin again. Then Iraq's Hussein invaded Kuwait and added war fears to the existing fear of recession. This additional fear and the public's response to it make recession more likely.

As we wrote in Iraqnaphobia, the economic effect of increased oil prices and a prolonged slowdown/recession is to lower corporate values by 5 to 10 percent. But prices at any given time are determined by a combination of economic values and emotional responses. Right now, emotions are driving prices.

A glaring example is the price of oil. Three months ago, oil sold for \$16 to \$18 a barrel. On October 9th, it hit \$40 and traders who forecast \$50-\$60 were quoted on the news. But the removal of Iraq and Kuwait's production of 4 to 5 million barrels per day has been nearly offset by increased production from other OPEC members. Those who have done supply

demand studies conclude that the economic price of oil is \$22 to \$27 per barrel. Thus, the current \$40 price includes a \$15 war premium, and the \$50 to \$60 guesses are based on a shooting war that destroys oil facilities. But this too could be temporary. It's ironic that Hussein's stated goal in the OPEC meetings (before he invaded Kuwait) was a price of \$25 per barrel. Now the price is \$40 but the world refuses to buy his oil.

Similarly, stock and bond prices are set by a combination of long-term economic values of underlying companies and the current level of fear or hope in the marketplace. Today, we see many examples of companies and executives buying their own stock because the "price is cheap" and "it's a good value." At the same time, the public is selling because "the price is down and we fear it may go lower." The last time we saw this dichotomy was in late 1987.

In such circumstances, we find it useful to step back and broaden our horizon. Specifically, we ask ourselves: What is the likely duration of a war and/or recession? Does it threaten U.S. national security? What will be the value of specific companies when it is over? Three years

ago; for example, we would have feared a superpower confrontation. Today, that's not a threat. When we look at individual companies, we find a lot of good ones that are cheap, some compellingly so. Many of these are the same companies whose insiders are buying their stock. Some are companies we already own at higher costs. Some are companies in which we sold positions earlier this year because they appeared fully valued. Others are companies that we haven't seen at such attractive prices since late 1987, the last time fear was rampant. We've begun to nibble at the stocks of these companies. So far, we're only nibbling because:

1. The news from Iraq-Kuwait may get worse on a short-term basis.
2. Our Federal Reserve is partially constrained by Iraq-Kuwait and by the falling value of the dollar. Chairman Greenspan has also tied Fed easing to Congressional actions on the budget; our representatives in Washington are dithering to no end on this one.
3. We expect tax-related-selling pressures through year-end.

AN OPEN LETTER TO MY CONGRESSMAN:

Dear Congressman:

I am disturbed by the current state of affairs in Washington, D.C. You and your colleagues in Congress are addressing issues important to the future of our nation and our economy. Here are my thoughts on these issues:

Congress and the executive branch maintain that our biggest problem today is the budget deficit. The deficit has two parts - taxes and spending. Many would like to shrink the deficit by raising taxes, but we've tried that and it doesn't work. During the 1970s, we allowed inflation to raise effective tax rates to the highest level in our nation's history. People quit working and the result was 10% unemployment and 10% inflation. I'd like to make several points about taxes:

First, the focus seems to be on taxing the wealthy by raising income tax rates. Income is not wealth; wealth is assets. When you tax income, you tax those who are trying to become wealthy, not necessarily those who already are.

Second, a simple definition of wealth versus poverty is that the wealthy have more options. There would be no point in trying to become wealthy, through concentrated time and effort, if it did not increase your options.

Third, in the final analysis the payment of taxes is voluntary. You can tax my income, but you cannot force me to earn it. Much of the political and economic dialogue of the past decade concerned the maximum tax rate at which people are encouraged to earn the most and, not incidentally, to pay the most taxes. Two of my offspring received their first real paychecks this year, and judging by their reactions to the amount withheld for taxes, we're pushing the limit. I know you're pushing my limit! If you raise my tax rates, I'll do less work. Even a mule will quit if you load him too heavily, and most people are smarter than mules.

AN OPEN LETTER TO MY CONGRESSMAN: (Continued)

If income taxes are too high, the wealthy will simply buy municipal bonds, or they'll buy farmland and get paid *not* to grow food. Doctors will defer income or play golf. Businesses will be managed to minimize taxes rather than to grow and to create new products and new jobs. This isn't hypothetical; we saw all of the above in the 1970s. They gave us 10% inflation and 10% unemployment. Do we really wish to return to those circumstances?

Among all income taxes, the most voluntary is capital gains. The truly wealthy, having the most options, can live off their dividends and interest. They have no need to sell appreciated assets.

Ronald Reagan knew that people work harder and produce more if you lighten the tax load. (Maybe it was his experience with horses.) So he lowered tax rates and people went to work, creating over twenty million new jobs. (Politicians don't seem to understand how jobs are created. Jobs are created when one person can benefit or profit from hiring another. If you tax away the profit, you tax away the job.) They also paid more in taxes. By 1990, federal tax receipts exceeded 1980 receipts by more than \$240 billion per year, adjusted for inflation. In your wildest dreams, you've never imagined a "peace dividend" of \$240 billion per year. Yet we have a "growth dividend" of \$240 billion per year in tax receipts! Surely that's enough. But no, federal spending has grown even more.

Congress makes noises about cutting spending, but I see no real effort to do so. In the current year, each appropriations bill that went through the House was loaded with pet projects and pork barreling. Not one bill was held to the overall budget limits! In your recent newsletter, you said you voted to limit spending on a number of provisions in these bills, but you never mentioned whether any actually passed. One was a provision to limit subsidy payments to farmers earning over \$100,000 per year, hardly a draconian cut. The provision failed in the House by a 2 to 1 margin. This says to me that Congress is not interested in cutting subsidies, even to the wealthy. You said at a recent town meeting that the effect of special interests in Congress is limited because you must get 218 Representatives on the same side to pass anything. Yet experience shows that when a Congressman adds pork to a bill, it stays in. No Congressman has an incentive to delete another's line items, and the President isn't allowed to. The result is in an inherent bias toward spending, which I've encouraged you to remedy by supporting a fine-item veto.

I've noticed that your town meetings are well attended by people who receive checks from the Federal government. Invariably they want more, and certainly not less. My wife characterized the theme of a recent meeting as "gimme". After attending a number of these meetings, I can understand why members of Congress believe they are elected to spend more money. Nevertheless, at election time the taxpayers have sent clear signals for over a decade that they're carrying as big a load as they're willing to carry.

So you're faced with a dilemma: How to keep your promises to the recipients of federal programs without raising taxes? The answer is - you can't! You've promised money you don't have, and you've promised money the taxpayer is unwilling to pay. For a decade we've made up the difference by borrowing, but we've exhausted our credit.

One of the great dangers of the current circumstance is that the dichotomy between taxpayers and recipients has become inter-generational. While taxes are paid by working people, sixty percent of Federal outlays go to senior citizens and retirees. And the percentage is still climbing! In a recent debate, a spokesman for a senior group said that "Other than cost of living (adjustments), Social Security benefits to a retired individual haven't been raised since 1972. I don't know why these raises should exceed the cost of living in the first place, but as an individual worker my Social Security taxes have *tripled in* real terms since 1972. I'm 46, and I've already paid more in Social Security taxes than someone who retired 5 years ago. At the same time, anyone, rich or poor, who has been retired for five years has already received more from Social Security than they ever paid in, again adjusted for inflation. Enough already!

Entitlement program such as Medicare, farm subsidies and Social Security are always justified based on the financial need of the poorest participants. But the benefits paid out are not determined by need. As a consequence, the benefits go disproportionately to those who are not needy. The bulk of farm subsidies go to wealthy farmers. Wealthy retirees pay only 25% of the cost of their Medicare benefits. Five hundred thousand millionaires will receive Social Security benefits which exceed five times what they paid in. Taxpayers pay the rest - how is this equitable?

Congress is trying to cope with the intergenerational problem; in it's own way. At the insistence of a group of senior citizens, Congress passed the Medicare Catastrophic Coverage Act of 1988, and provided that it be paid for by Medicare participants. Once they saw the cost, a larger group of senior citizens immediately got the bill repealed.

Several years ago, Tip O'Neill proposed taxing 85% of Social Security benefits. At the time, I wondered how he came to the 85% number. He used a study that concluded that the average Social Security recipient would receive benefits roughly seven times what he paid in. Or, put another way, of the benefits received, only 15% represented personal contributions. Tip proposed taxing the other 85%. The proposal went nowhere, but the idea was again floated at the recent budget summit. Taxes would have been progressive, affecting only those retirees earning more than \$25,000 per year. But at the first whisper of "tax Social Security" a great hue and cry shot the idea down. So the summiteers turned to Medicare. I'm embarrassed at how long I thought Medicare was for poor people. Then I learned that Medicaid is for poor people. Medicare is simply for people over 65, rich or poor. Today, these people directly pay 25% of the cost of their Medicare. The budget summit proposed raising this to 30% through higher deductibles and co-payments. Again the great hue and cry! I can sympathize with the complainers; I don't like paying the cost of medical insurance either, but I don't expect you to tax them to subsidize me.

I don't object to subsidizing the needy. But, as currently run, "entitlement" programs tax me and my children to subsidize people who are better off than we are, simply because they've reached a certain age. A senior citizen told me he counted on Social Security and Medicare to provide a cushion to prevent his being a burden to his children. Someone should tell our seniors that the biggest financial burden their children have is paying for Social Security and Medicare!